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COLLEGE OF COMMERCE AND ADMINISTRATION

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COLLEGE OF COMMERCE AND ADMINISTRATION

FOREWORD

The Annual Institute on Accounting, which is sponsored by The Ohio State University, has become a national institution. With the enthusiastic support and cooperation of members of The American Institute of Accountants, The National Association of Cost Accountants, The Controllers Institute of America, Inc., The Institute of Internal Auditors, Inc., The American Accounting Association, and The Ohio Society of Certified Public Accountants, this conference has, during the past twelve years, grown to a stature that ranks it as one of the great annual meetings of the nation for industrial, public, and governmental accountants.

The Eleventh Annual Institute was held at Columbus, Ohio, on May 20 and 21, 1949. It was planned as part of the year-long celebration of the Seventy-Fifth Anniversary of The Ohio State University. "Growth Through Service" has been the keynote of this educational institution. The College of Commerce and Administration is fortunate and proud to serve the profession of accounting and, through it, the nation's economy by arranging these programs for extension of the training and thinking of the large number of business executives, fiscal officers, controllers, and accountants who attend year after year.

These proceedings are made available by the University as a part of its contribution and service to the business public. With the cooperation of the Bureau of Business Research, publication is made possible and distribution of the record of the conference technical papers is effected.

A debt of sincere gratitude is acknowledged to all who participated in the Eleventh Annual Institute and to the many others who contributed to its success in the behind-the-scene arrangements.

HERMANN C. MILLER
Chairman, Department of Accounting

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FIRST SESSION

FRIDAY, MAY 20, 1949—10:00 A. M.

Deshler-Wallick Hotel

Chairman:

OLIVER W. SEIFERT, *President, Ohio Society of Certified Public Accountants; Deloitte, Plender, Griffiths & Co., Cincinnati, Ohio*

Address: "National Security Programs in Periods of Price and Volume Changes"

RALPH J. WATKINS, *Director of Research, Dun & Bradstreet, Inc., New York, New York (Currently on part-time loan to the National Security Resources Board as Director, Office of Plans and Programs)*

Address: "New Financial Statements for New Price Levels"

HOWARD C. GREER, *Vice President, Kingan & Co., Indianapolis, Indiana*

INTRODUCTORY REMARKS

MR. OLIVER W. SEIFERT: I am grateful for the privilege of extending to each of you a sincere and personal welcome to the Diamond Jubilee Institute on Accounting, celebrating the 75th year of existence of Ohio State University. This is the Eleventh Annual Institute on Accounting sponsored by the Department of Accounting. We are meeting at the hotel this year due to the building construction now under way at the University.

An excellent program of outstanding speakers on timely subjects has been provided which, I am sure, will make this meeting an outstanding contribution in the way of accounting meetings.

You have all been provided with a copy of the program and have noted that the general theme of the meeting is "Changing Business Conditions and Accounting Theory and Practice."

We are very fortunate in having with us this morning two outstanding speakers and authorities on their respective subjects.

Our first speaker will discuss "National Security Programs in 1949 and 1950." He is particularly well qualified to discuss this subject because of his broad and varied experience which includes more than twenty years in the administration and conduct of business and economic research at the University of Texas, Ohio State University, National Bureau of Economic Research in New York City, the University of Pittsburgh, and in the Federal Government. At the University of Pittsburgh, he directed, for nine years, a broad program of regional economic research in cooperation with the industries and trades of that center of heavy industry.

Upon the outbreak of World War II, he was called to the National Resources Planning Board, where he served as Economic Adviser and later as Assistant Director. During the war years, he had numerous special assignments with the war agencies. In 1942, he was appointed to the Federal Anthracite Commission by the President, and was the United States Government delegate to the International Coal Conference at Geneva, Switzerland. He had supervised major research studies on the coal, petroleum, iron and steel, and transportation industries, and in the field of industrial location.

He served as an advisor on reconversion to the War Production Board prior to accepting the position as Director of Research of Dun & Bradstreet, Inc. He is currently on part-time loan to the National Security Resources Board as Director of the Office of Plans and Programs. As you know, the National Security Resources Board is the top-flight defense board which advises the Administration on military, industrial, and civilian mobilization plans.

I am sure that you will agree with me that we are fortunate in having someone with such a wealth of experience and background to speak to us on the subject of "National Security Programs in Periods of Price and Volume Changes."

It is with great pleasure that I present to you Mr. Ralph J. Watkins. Mr. Watkins.

NATIONAL SECURITY PROGRAMS IN 1949 AND 1950

By Ralph J. Watkins
Director of the Office of Plans and Programs,
National Security Resources Board, Washington, D. C.

It is a high honor and a great privilege to be with you today at the opening of your eleventh annual meeting and in particular to share with you this part of the celebration of the 75th anniversary of The Ohio State University. I cherish happy memories of the three years of my association with O.S.U., and I assure you it is a deeply satisfying experience to return to Columbus and especially to be able to greet my friends and former colleagues of two decades ago.

In discussing the topic which you have assigned to me, I find myself unavoidably in the role of seer and prophet. In consequence, I must not only ask your indulgence; I must, at the outset, enter the caveat that I shall express here my personal views, opinions, and prophecies. They do not necessarily reflect the views of the National Security Resources Board, with which I have been associated on a part-time basis since early in 1948. Individuals lacking the niceties of discretion often engage in the folly of prophecy, but institutions cannot afford that luxury.

Magnitudes of National Security Programs

The Federal Government will probably spend, in the fiscal year which begins on July 1, next, more than $22 billions on national security programs. Those expenditures will likely account for somewhat more than half of the Federal Budget, and will probably represent in the neighborhood of 8 to 10 per cent of the total value of all the goods and services produced by the American economy during that year. Moreover, this level of expenditure on national security programs will represent a stepping up from the level of the current fiscal year by close to $3 billions.

These new figures make it clear that in the national security programs we are confronted with magnitudes of great significance to the economy of the Nation. It is clearly incumbent on businessmen to seek an understanding of these programs and of their implications.

The Setting

We live in an uncertain world. Twice within the maturity of many us here the world has been plunged into the holocaust of global war. And each of those wars has left a wake of deep disturbance and instability. Even at the close of World War I, it became apparent to those with statesmanlike vision that the position of the United States in the world has been profoundly altered; that fate and circumstance had lifted us to a position of pre-eminence in the world; and that we must live up to the obligations of that position. It remained, however, for the cataclysmic changes wrought by World War II and its aftermath to bring these lessons home to all of us.

There are in the world today just two great focal areas of power, symbolizing two wholly divergent systems of values. One of these is the fatherland of World Communism and symbol of the Police State. The aggressive march of that revolutionary system over a large part of the world has made headline news almost daily for four years, and is today engulfing the world's most populous nation. The other focal area of power is the United States of America, heir of western civilization and symbol of the basic principles of the dignity of man, freedom, justice, and the rule of law. Today it is clear throughout the length and breadth of our land that Providence and history have now assigned to us the role of leadership among the free peoples of the earth. On our shoulders rests the burden of upholding the supremacy of freedom in the world.

What I have said thus far has been designed to place our national security programs in their proper setting. Let us examine their origin.

National Security Act of 1947

Basically, the national security programs stem from the National Security Act of 1947, enacted in July of that year. In that Act, the Congress declared the intent "To provide a comprehensive program for the future security of the United States; to provide for the establishment of integrated policies and procedures for the departments, agencies, and functions of the Government relating to the national security; . . . and to provide . . . authoritative coordination and unified direction" of the Army, the Navy, and the Air Force. Title II of the Act established the National Military Establishment, under the Secretary of Defense, and spelled out in some detail the organizational structure of the Military Establishment. I wish to direct your attention, however, to the lesser known Title I of the Act under the heading of "Coordination for National Security." That Title established three new agencies which already have had a profound effect in shaping our national security programs and which, in my judgment, are destined to have a still more profound effect in the years ahead. These three agencies are the National Security Council, the Central Intelligence Agency, and the National Security Resources Board.

NATIONAL SECURITY COUNCIL

The National Security Council, consisting of the President, the Secretary of State, the Secretary of Defense, the Secretaries of the three Armed Services, and the Chairman of the National Security Resources Board, has the function of advising the President with respect to the integration of domestic, foreign, and military policies relating to the national security, in order to permit more effective cooperation among the departments and agencies of the Government in matters involving the national security. The Act specified also that, under the direction of the President, the Council should assess and appraise the objectives, commitments, and risks of the United States in relation to our actual and potential military power, and make recommendations to the President accordingly.

Through the machinery of the Council, there is continually brought to the President an integrated view of foreign policy, military policy, and resources policy; and there stems from the work of the Council a coordinated approach to action and policies in each of these fields. Already, the Council has played a brilliant role, in the formulation of national security policies and programs, and, in my judgment, it will play an even greater role in the future.

As an example of the work of the National Security Council, the Berlin Airlift Chapter may be cited. When the Soviet land blockade was put into effect about a year ago, the American Government faced a crucial decision. Our small forces were surrounded by overwhelmingly superior Soviet forces. To supply allied forces and the civilian economy of the Western sector would involve great expense and would also commit in a highly exposed position a large part of our transport aircraft. From both the military and the economic standpoint, strong arguments could have been advanced in support of withdrawal of our forces from Berlin. On the other hand, the international political consequences of withdrawal were grave indeed. The National Security Council carefully weighed the military, political, and resources factors involved and concluded that we should maintain our position in Berlin, and the President so decided, authorizing the appropriate expansion of the Airlift. It was a fateful and historic decision, and our grandchildren will read of it. The point I wish to emphasize, however, is that that decision was arrived at through the intelligent coordination of foreign, military, and domestic policy in the interest of national security—through machinery designed by the Congress for that specific purpose.

Still another example is the Atlantic Pact. In the summer of 1948 the National Security Council recommended, and the President approved, the initiation of negotiations. In the same way, the development of the military assistance program was initiated. Both the Atlantic Pact and the military assistance program involved a coordination of foreign policy, military policy, and resources policy, involving the assessment and appraisal of "objectives, commitments, and risks," including the always serious problem of impacts on our economy or resources.

Central Intelligence Agency

The Central Intelligence Agency was established, under the National Security Council, for the purpose of coordinating, in the interest of national security, the intelligence activities of the several Government departments and agencies, and to give appropriate advice to the National Security Council in intelligence matters. In the sort of world in which we live, it is difficult to overemphasize the high importance of this intelligence work in the shaping of national security policies and programs.

National Security Resources Board

Let me next direct your attention in some detail to the third of these national security agencies established under Title I of the National Security Act of 1947—the National Security Resources Board.

The Act assigned to that Board the responsibility of advising the President concerning the coordination of military, industrial, and civilian mobilization, including advice to the President on certain specific matters having to do with effective mobilization of resources in the event of war, and with certain economic readiness measures against the contingency of war. Thus, these functions make of the National Security Resources Board a resources mobilization planning agency, set up to advise the President. It is important to note that the Board has no operating functions whatsoever, in the governmental sense of the term; its sole duty is to advise the President.

These specific statutory matters just mentioned, on which the Board must advise the President, as described briefly as follows:

1. Policies to assure the most effective mobilization and maximum utilization of the Nation's manpower in the event of war.
2. Programs for the effective use in time of war of the Nation's natural and industrial resources for military and civilian needs, for the maintenance and stabilization of the civilian economy in time of war, and for the adjustment of such economy to war needs and conditions.
3. Policies for unifying, in time of war, the activities of Federal agencies and departments concerned with resources mobilization.

4. The relationship between potential supplies of, and potential requirements for, manpower, resources, and productive facilities in time of war.
5. Policies for establishing adequate reserves of strategic and critical materials, and for the conservation of these reserves.
6. The strategic relocation of industries, services, government, and economic activities, the continuous operation of which is essential to the Nation's security.

I think you will agree with me that these functions are tremendous in their scope and in their implications. Likewise, you will agree with me that they are so appalling in their complexity that honest men can approach them only in a spirit of deep humility.

Purpose of Resources Mobilization Planning

The purpose of the resources mobilization planning on which the National Security Resources Board is engaged is: (1) to provide the basis for advice to the President from time to time as to steps which should be taken to improve the readiness position of the country against the contingency of war; (2) to have available for the President, in the event of war, well articulated plans for a rapid mobilization of the resources of the Nation.

It has been well stated that the aim of economic policy in time of war is to minimize economic barriers to military and other action against the enemy. In the same sense, we may say that it is the aim of resources mobilization planning in time of peace to remove or to minimize resources barriers to possible future military and other action against an enemy in the contingency of war. In other words, we seek in time of peace to do those things which will help to maximize our striking power—military, economic, and psychological—in the event of war.

Philosophy of Mobilization Planning

The philosophy of mobilization planning, both military and economic, rests on the premise that a state of preparedness is one of the means of lessening the likelihood of an aggressive attack against the Nation, and, at the same time, one of the means of increasing the likelihood of winning a war, if the Nation is forced into war. In the uncertain world in which we live, we can with prudence do no less than to take appropriate steps to improve our economic readiness position against the contingency of war, and to lay plans for the rapid and effective mobolization of our resources in the event of war.

It must be clear to all the world that the American nation is not preparing for war. Only an aggressor nation that has made the decision to wage war can direct all its energies toward preparation for war. A free society, on the other hand, can plan only for those measures which are determined to be necessary for mobilizing its resources, in the *event of war*. Nor does the conscious national decision to plan against the contingency of war carry any implication whatever that war is inevitable or even probable.

On the contrary, it is abundantly clear that the fundamental program of the Amercan Government is one of planning for peace, not war. Despite the allocation of more than half of the Federal budget for national security programs, it must be emphasized that our total national activity is overwhelmingly dedicated and directed to the requirements of a peacetime economy and a world at peace. For this comparison, the national security programs of more than $20 billion must be compared with a gross national product in excess of $250 billion.

Our national security programs must be considered not only as national insurance against the hazard of war, but, particularly in their international phases, as an investment in the preservation of peace and freedom in the world. In his Budget Message to the Congress, the President has made clear the concept of the national policies which we are following. For example, he stated that "The principal objective we should have in mind in planning for our national defense at this time is to build a foundation of military strength which can be sustained for a period of years without excessive strain on our productive resources, and which will permit rapid expansion should the need arise." He has likewise referred, in discussing the large international items in the budget, to the "strong economic support we are extending to the free nations of Western Europe, whose recovery is the key to continued independence and to safeguarding freedom in many other parts of the world," and that "our investment in European recovery will repay us many times in terms of increased strength and improved organization for peace." With reference to his intention later to request funds for providing military supplies to Western Europe and certain other countries, he added that "in existing circumstances, economic strength is not enough to assure continued independence to free peoples."

Budgeted Programs

The national security programs under discussion consist of the budgeted programs for: (1) the National Military Establishment; (2) the Stockpiling Program; (3) the International Aid Programs; (4) the Atomic Energy Commission; (5) the Merchant Shipbuilding Program; (6) Economic Readiness Measures in the Federal Budget for (a) expansion of power generating facilities; (b) construction of strategic highways;

Budget Authorizations and Estimated Expenditures for Selected National Security Activities*

(As Shown in The Budget of the United States Government for the Fiscal Year Ending June 30, 1950.)

Activity	Fiscal Years—In Millions New Obligational Authority [1]			Estimated Expenditures		
	1949	1950	Increment	1949	1950	Increment
National Defense						
National Military Establishment	$13,782[2]	$14,516[2]	$ 734	$11,330	$13,136	$1,806
Activities Supporting Defense						
Stockpiling	835	525	— 310	350	525	175
Universal Training (Proposed)	0	800	800	0	600	600
All Other	41	36	— 5	65	7	— 58
Total, National Defense	14,658[2]	15,877[2]	1,219	11,745	14,268	2,523
International Affairs and Finance (Mostly foreign aid and foreign relief)	8,892	6,349	— 2,543	7,219	6,709	— 510
Atomic Energy Commission	662	792	130	632	725	93
U. S. M. C. Merchant Shipbuilding Program	104	112	8	26	121	95
TOTAL	$24,316*	$23,130*	—$1,186*	$19,622*	$21,823*	$2,201*

* This tabulation does not include obligational authority or estimated expenditures under the proposed military aid program; also it does not reflect (1) revisions in Presidential recommendations made subsequent to the submission of the Budget in January, 1949, or (2) increases or decreases voted in House appropriations bills. See text for clarification of these excluded items.

1 New obligational authority includes actual and recommended net new appropriations and other authorizations (e.g. contract and loan authorizations), and excludes appropriations to liquidate prior year contract authorizations.

2 Includes $2.9 billion (largely aircraft) for 1949 program provided in fiscal year 1948 supplementals; excludes $279 million being made immediately available in fiscal year 1949 to cover increased cost of completing authorized naval ship construction program, which is included in fiscal year 1950 figures.

(c) modernization of Federal airways; (d) exploration and development of scarce minerals; (e) development of certain strategic areas; (f) development of synthetic fuels; and (g) others of a like nature.

On the accompanying tabulation, I have listed the figures from the Budget Message of the President of January 10, 1949, on new obligational authority and estimated expenditures for Fiscal 1949, which ends June 30 next, and for Fiscal 1950, which begins July 1 next.

No figures are included for the previously enumerated economic readiness measures because of the difficulty of differentiating between developmental and construction programs included in the budget for national security reasons, and those included solely because of their peace-time contributions. Most of such programs, in fact, have both national security and peace-time justification, but no criteria are available for earmarking each such proportion. It is clear, however, that economic readiness measures of the sorts indicated in my earlier listing must amount to several hundreds of millions, and possibly to one-half billion.

For example, the natural resource programs (exclusive of the Atomic Energy Commission) and the transportation and communication programs (exclusive of the shipbuilding program) call for estimated expenditures in Fiscal 1950 of $2.6 billions. It may well be that one-fifth of the total finds a national security justification.

New obligational authority for the national security programs as listed in the table, for Fiscal 1950, has been recommended by the President at $23.1 billions. Estimated expenditures for Fiscal 1950 aggregate $21.8 billions, or an increase over the estimate for Fiscal 1949 of $2.2 billions. It will be observed from the footnote, however, that this tabulation does not include obligational authority or estimated expenditures under the proposed military aid program; it does not reflect (1) revisions in Presidential recommendations made subsequent to the submission of the budget in January, 1949, or (2) increases or decreases voted in House appropriations bills.

Expectations

At this point, let me confess to my embarassment over the attempt to arrive at reasonable expectations as to Congressional appropriations at this particular time in the calendar year or even as to estimated expenditures. Your Program Committee doubtless had sound reasons for selecting this date of May 20, but the sweat and tears I have suffered—and inflicted on others—over the remarks I am about to make are a reminder to me that hereafter I should hold out for a date on or shortly after the 1st of July!

But the effort must be made so I have polished my crystal ball as best I could. I hope, however, that at least I have your sympathy. And let me repeat that such prophecies as I shall indulge in shall be entirely personal and not in any sense official.

As far as the present fiscal year is concerned, inspection of the Daily Statement of the United States Treasury indicates to me that national security program expenditures will probably not exceed 19 billions, or slightly under the total shown in the table for Fiscal Year 1949. Let me repeat, however, this is my personal guess. But when we come to the matter of probable revisions for Fiscal Year 1950, that is a horse of a different color —and considerably tougher to ride, or even to mount. There are, however, a few figures that may be cited. The President has lowered his earlier budget recommendation for the European Recovery Program by a little over $100 million for Fiscal Year 1950, in addition to a reduction of about $175 million for 1949.

The House of Representatives has increased the President's Military Establishment budget recommendation by more than $600 million. On the other hand, figures in the table for Universal Training remain today, as they stood on January 10, 1949, merely as proposed programs. Thus, the increase by the House in the Appropriation Bill for the National Military Establishment falls a little short of offsetting this proposed program on which no specific legislation request has been submitted to the Congress.

There remains the significant item of military aid. The Secretary of State, in his statement of April 27 to the Senate Foreign Relations Committee on the Atlantic Pact, stated, on the subject of military aid, that: "the proposed program will request authorization and appropriation of $1,130,000,000 for Atlantic Pact countries, and approximately $320,000,000 for other countries, including Greece and Turkey, making a total of $1,450,000,000 for the Fiscal Year 1950."

Casting up a balance among the items mentioned, including some small revisions not mentioned, and on the assumption that there will be no action on the proposed Universal Training Program for 1950, and assuming Senate concurrence in the House Military Establishment increases, I arrive at a revised total of estimated new obligational authority in Fiscal Year 1950 for these national security programs of approximately $24 billion.

On the same assumptions—which I must emphasize may be hazardous —and taking into account some lag in the rate of expenditures, I should guess that total expenditures for Fiscal Year 1950 for these national security programs may run to around $22 billion. This total would represent an increment over the corresponding total for Fiscal Year 1949 of around $3 billion.

What Are the Basic Factors in Analyzing the Impacts of These National Security Programs

In the interest of economy of time, I shall merely state briefly the factors which I regard as salient:

1. At the beginning of 1949 it could be said that we had experienced "full employment" or near-capacity operations in our economy for about seven years. For the first half of that period, we must admit that this full employment was brought about by war, and not by our cleverness. And what of the second half of this seven-year span, or the three and a half years following V.J. Day? Although I am willing to impute to national policy its appropriate share of the credit, I am convinced that objective analysis must point to the aftermath of World War II as the primary influence. What do we mean by this aftermath of war? Just two things:

a. The enormous accumulated shortages at the end of the war of both capital goods and consumer goods; and

b. The unprecedented volume of money savings from the war period which made it possible to convert these unsatisfied wants into effective demand.

Aiding and abetting these aftermath-of-war influences has been the technological revolution that has occurred in certain fields, notably in electronics and in the chemical industries, and, to a lesser extent, in many other fields. This technological revolution is, in part, itself an aftermath of war, since it represents in part the application to peacetime industries of the telescoped progress of science under the impetus of war. This technological revolution has represented the practical utilization over a brief period of the scientific and engineering developments that have been accumulating not merely since the end of the war but since the 1929 crash.

2. Four and a half months ago, concern was expressed in some quarters over the possible inflationary effects of superimposing the prospective national security programs, with their rising trend, on an economy operating at near capacity levels, although it was apparent even then that the major inflationary influences had largely spent their force.

3. In the intervening months since the first of the year, a distinct change has occurred in the climate of opinion, in consequence of the increasing evidence of the shift generally from a seller's market to a buyer's

market. As a result of this change, the rising trend in national security program expenditures is looked to hopefully as one of the major sustaining factors in our economy.

On the subject of trends and increments, it may be noted also that the President in his Budget Message has put the Congress and the Nation on notice that, even to maintain the present program, "Defense expenditures . . . are expected to be higher in 1951, as a result of expanding programs now under way and the large orders already placed for aircraft, ships, and other material and equipment, which will be delivered and paid for in the next few years."

With all due allowance for the fallibility of the estimates I have hazarded in these remarks, I think I can safely say that these national security programs represent magnitudes of major consequence.

Representing, as they will, something like 8-10 per cent of the gross national product, they will have a significant impact on the economy. Indeed, it is increasingly clear that the policies and programs of the Federal agencies in the field of national security must inevitably have a profound effect on the Nation's economy. There is no escape from this Nation's role of leadership among the free peoples of the world, and that role will more and more call for the continued formulation and strengthening of positive programs aimed at maintaining intact the heritage of free societies, here and abroad.

CHAIRMAN SEIFERT: We are very fortunate in having as the next speaker at this Diamond Jubilee Institute on Accounting one of the principals in the founding of the Department of Accounting at Ohio State University. He was professor of accounting at this University from 1922 to 1927 and has also served at various times as a member of the faculty of the School of Business, University of Chicago, and College of Commerce, Northwestern University.

Upon leaving the educational field, he became an executive of the American Meat Institute. Because of his outstanding record in this capacity from 1927 to 1939, the management of Kingan and Company, Incorporated, prevailed upon him to join their organization as Vice President and General Manager, which position he held from 1939 until May 1 of this year. He is now a director and management consultant for this company, and also vice president and director of the Chicago, Indianapolis and Louisville Railway Company.

In addition to his administrative work in industry, he has maintained his interest in accounting and continues to make a contribution to its progress as is witnessed by his presence here this morning.

He is a Certified Public Accountant of Illinois and Ohio. A member of the American Institute of Accountants and the American Accounting Association, of which he was president in 1932. He is a member of the National Association of Cost Accountants and was honored as a Director from 1945 to 1948.

He is the author of a number of outstanding books, "How to Understand

Accounting," "Chain Store Accounting," "Furniture Store Accounting," "Accounting for a Meat Business," and "Cost Accounting Problems" with our good friend, Russell Willcox. He has also written numerous articles for *Accounting Review*, *Journal of Accountancy*, *NACA Bulletins*, and other publications.

He is, therefore, particularly well qualified to speak to us because of his broad experience as an educator and industrialist, knowing both the theoretical and practical aspects of accounting, and the problems encountered in the preparation of financial statements under varying price levels.

I know of no business where the prices vary more than in the meat packing industry, and in my close association with Mr. Greer in the examination of the accounts of Kingan, I have come to respect his judgment very highly. I am sure you will agree with me when you have heard his discussion on the subject, "New Financial Statements for Price Levels."

It is with very great pleasure that I present to you Mr. Howard C. Greer. Mr. Greer.

NEW FINANCIAL STATEMENTS FOR NEW PRICE LEVELS

By Howard C. Greer
Corporation Director and Management Consultant

With present price levels about double those of a decade ago, there are many complaints that conventional accounting statements do not now accurately measure operating profits or capital equities. Critics point out that the cost of replacing worn-out fixed assets far exceeds the amounts "provided" through depreciation charges based on original costs incurred in pre-war years. They emphasize that owners' "economic" capital actually has shrunk if its dollar amount has not increased to the extent of the advance in prices. They deplore the fact that orthodox financial statements give no recognition to these indisputable facts.

It is suggested that accounting procedure should be so modified as to include in the determination of net income a charge equivalent to the replacement cost of all physical assets sold, exchanged, consumed, or worn-out in producing the gross revenues earned. It is asserted that only by this means can "true" (economic) profit by calculated and owners' "real" (economic) capital be "protected." It is urged that under such a procedure both tax collectors and wage earners would take a more tolerant and realistic view of business profits and would modify their exactions accordingly.

The arguments are impressive. They are fortified by the genuinely serious capital shortage which has been developing in American industry in the wake of a period of apparently phenomenal profits. Whatever the published reports may imply, profits in most industries have been wholly inadequate to perform their normal function in an expanding economy. Whatever their stated dollar amount, they have not been sufficient to provide for replacement of wasting plant and equipment, either through attracting additional investment from without, or producing adequate capital from within.

Under normal conditions, with prices reasonably stable, business capital requirements are met in substantially the following way: with a "break-even" result, cash will accumulate to the extent of depreciation charges; this will be sufficient to replace in kind the fixed assets which have worn out or become obsolete; any profit earned will also be reflected in an accumulation of cash, which can be used partly for dividends and partly for business expansion, in such proportions as circumstances warrant. In periods when business has been genuinely profitable, in a marked degree profits have served both purposes—ample dividends have encouraged increased equity purchases by investors, yet have left in the business sums sufficient not only for replacement but also for improvements and expansion of productive facilities.

Contrast this with today's conditions, in which corporation managers have been forced to restrict dividend distributions to a subnormal percentage of stated earnings (to bolster working capital and to supplement depreciation provisions which are inadequate for asset replacement), while returns on equity investments are so limited and uncertain that the public will not buy either new or old stocks except at substantial discounts from conservatively stated book values! It is hardly surprising that owners, managers, bankers, security dealers, and economists have a quarrel with the accountant if his report indicates that results are satisfactory and capital resources adequate when common sense makes it evident that they are not.

The question is whether the accountant should try to resolve the difficulty by changing his method of measuring income and capital, and what would happen if he did. This question must be considered in the light of past developments, current conditions, and future probabilities. It must be studied in terms of the long-range effect of any new departures on the interpretation of financial statements, their usefulness to owners and investors, and their influence on public policy. In this connection, the purely mechanical problems of intelligible reporting also deserve at least minor attention.

There already is an extremely extensive literature on the subject. A casual reviewer will find upwards of twenty articles on this topic in accounting publications alone, and there are innumerable discussions of the problem in the public utterances of leading business men, trade association executives, labor representatives, economists, law-makers, and public administrators. Spokesman for business are almost unanimous in demanding some change in the measurement and reporting of profits. Many prominent accountants are either vigorously or cautiously sympathetic toward the business view. Economists go further, asserting flatly that that conventional accounting "mis-states" current profits. Labor leaders ridicule this contention.

A new contribution at this late date can add little to the arguments in favor of a change of approach to the problem of income measurement. It may be worth while, however, to direct attention to some implication of the proposals which seem not to have been fully realized. Earlier articles by accountants (and other writers) are noteworthy for the absence of specific illustrations showing how the proposals would work out in actual practice. Only three of the many discussions coming to the attention of this writer have offered positive recommendations on the accounting procedure, and even these leave many aspects of the problem unconsidered.

This perhaps explains why accountants of the rank-and-file, while appreciating the difficulties of the present situation, have been so stolidly conservative in their attitude. They have sensed the impossibility of adopting a new standard of income determination and capital measurement without a complete revolution in orthodox accounting theory and practice. They feel unprepared to abandon their long-established methods until they can grasp more firmly the means by which the new concepts are to receive expression in their records and reports. The path through the ensuing maze of complexities certainly has not yet been made clear, even if the objectives can be accepted as wholly desirable of achievement.

What accountants, in effect, are being asked to do is to *stop keeping track of things in terms of money and start keeping track of money in terms of things*. This would involve a complete abandonment of money as a profit measure, and the substitution of index numbers for dollar signs as the hall-mark of correct accounting. It would require a new definition of profit, and an accounting differentiation between money income and economic income. The implications are rather staggering.

If there were to be any consistency and comparability in financial statements—as between industries, or individual companies in an industry, or succeeding years in the history of an individual company—some uniform conception as to current economic values would have to prevail throughout all industry and business. This presumes the authoritarian establishment of acceptable "yardsticks" of value (it is hardly imaginable that a million accountants, acting independently, would automatically reach an identical opinion on such a subject). Furthermore, the applicability of such yardsticks in the adjustment of money costs (and revenues) would have to be uniformly and universally accepted and understood. This would require a breadth of knowledge and a depth of insight which are certainly not possessed by a majority of accountants (or business managers) today.

As things stand now the calculation of the profit of a simple enterprise (or transaction) is not beyond the capability of an accountant with a modicum of training experience. From dollar revenues he subtracts dollar costs of goods sold and expenses incurred, including a deduction for some reasonable fraction of the initial cost of long-life assets partially worn out in the production of the goods or services sold. He is not concerned with what it would cost to replace the assets consumed, or whether they are to be replaced. He need not worry about how much of anything the remaining dollars will buy, or how they will be employed. He has quite enough to do apportioning dollar costs actually incurred between assets and expense accounts, without trying to deal also with hypothetical costs which might have been incurred in the past or may be incurred in the future.

For the average accountant, the task would be hopelessly complicated if he had to introduce into his accounts assumed replacement costs equivalent to assumed wear-and-tear losses in existing plant and equipment. He can apply the Lifo cost method to inventories and cost of goods sold, where actual replacements are involved, but he surely would have trouble with his depreciation charges on even a few hundred pieces of machinery, each with a different replacement cost level in each month of the year during which he has been patiently apportioning some part of their cost to the production for which they have been responsible.

Furthermore, the end-result of his calculations would be something he could hardly explain to any layman, if indeed to a fellow-accountant. What would be the significance of the accumulated "allowance for depreciation"? Would that sum replace the worn-out assets at current price levels? Not necessarily; not even probably, in view of the wide range of prices over a period of years. Would the stated net worth of the enterprise more accurately reflect the true economic value of the net assets? Quite the contrary, in a period of rising prices, when profit accretions would be reduced by increased depreciation charges. Would net worth increases be attributed only partly to profits, with the remainder arising from capital-growth of a non-profit character, and could the man-in-the-street be persuaded of the difference between the two?

Inevitably, it seems, there would be a divorce—or at least a "friendly separation"—between the income statement and the balance sheet. Their component elements could be reconciled only through a series of "adjustments" which would be an object of misunderstanding and suspicion among the uninitiated. It is easy to imagine the advantage which this condition would give those hostile to private enterprise, who would be quick to accuse businessmen of duplicity as well as avarice. Accountants would be perpetually on the defense, and much hard-won ground in the field of public respect would be inevitably lost.

Another serious objection to measuring profits in terms of changes in economic values is the difficulty of identifying the event which gives rise to a profit. Conventional accounting normally recognizes a profit only at the time of an exchange of goods or services for money consideration. Under the proposed concept there would be no profit if the goods exchanged were forthwith replaced with like goods costing as much or more as was received for those sold. If this theory were extended to cover anticipated or presumed replacement at some future date, what would be the test of profit realization?

A simple case exemplifies the difficulty. John Doe buys property in 1939 for $10,000 and sells it in 1949 for $20,000. It would cost $20,000 to replace the property at 1949 prices. Conventional accounting says there has been a $10,000 profit; tax law says this is a capital gain, subject to a levy of 25 per cent. The new theory says there has been no profit, because the revenue should be charged with "replacement cost" of identical amount.

Suppose John Doe convinces the tax collector that there has been no profit and then, instead of replacing the asset, puts his $20,000 in the bank. Suppose, too, that in 1959 he purchases the property for $10,000. He now has his original property and $10,000 in cash besides. Surely at some point (or points) during this period he has realized a profit.

When did this realization occur? Would he become taxable as the "economic value" of his bank balance swelled during the period of falling prices? And would the collector refund his tax if prices later resumed an upward course? Or would the act of replacing the initial investment determine the profitableness of the transactions, and how long would he wait for that to happen?

Altercations with the tax collector are not the only troubles which would beset the accountant. What would the profit be reported to the owners of a business which had a similar experience, and when would it become available for dividends? And how would a stockholder distinguish the distributions which he might receive as profits from those he might receive as a return of economic capital? Would he, too, have to become an expert in index numbers?

A part of this difficulty might be removed by providing that income could be charged with the cost of fixed asset replacements *when actually made*. In other words, a deduction might be made for either initial costs dissipated (depreciation) or for new costs incurred to make good the loss (replacement). The possible results of such a policy provide an interesting subject for speculation.

It is easily demonstrated that while prices are rising business enterprises have little free cash for either taxes or dividends, even though stated profits seem large, whereas in a period of falling prices cash often accumulates rapidly, even though deficits appear in the income statement. If the costs of replacements actually made were treated as expenses in a period of inflation, changes in profits might more nearly approximate changes in cash position, taxes would be lessened, and stockholders might be less clamorous for dividends. Conversely, later, replacements during a period of deflation would burden income less than depreciation on high-cost assets, and the conversion of receivables and inventories into cash might provide a source of funds for the tax collector at a time when the government had most need for them.

From the viewpoint of prudent management and wise public policy this proposition could be argued both ways. A reduction in stated profits during price advances might curb the enthusiasm which leads to over-expansion in peak periods; on the other hand, the opportunity to take a tax reduction for asset replacements might lead to even greater competition for materials and labor in periods of scarcity. By the same token, business might become less pessimistic in deflationary periods, being relieved of the income-account penalty of earlier follies and therefore more inclined to a normal capital-asset replacement program in dull times; public utilities, however, might have trouble in getting money for needed plant improvements in high-cost periods if their service charges in later years were likely to be based on the lower construction costs then prevailing.

The tax problem seems not too difficult of solution, once there is a general recognition of the need for keeping government expenditures within the means of the citizens who eventually have to shoulder the burden. Accelerated amortization was permitted in this country when plant expansion was an obvious essential for survival. England is now experimenting with inducements to greater outlays for industrial rehabilitation, by allowing deductions for all or part of new construction costs in lieu of depreciation based on original costs. The same thing could be done in any nation, with or without a revision of income measurement for ordinary purposes.

Another proposal which would preserve existing accounting principles is to supplement the conventional statements based on costs with a second set reflecting current replacement values in *all* sections of both income statement and the balance sheet. It admittedly would be confusing to report profits and financial position on two different bases at the same time, though hardly more so than combining elements of two conflicting viewpoints in a single statement. The supplementary statements, presenting "economic" income and capital, could be used only for those enterprises needing them and equipped to prepare them. They would have the merit of eliminating bookkeeping complications, and preserving the comparability of conventional financial statements, as between industries, companies, and periods of time.

Such statements would be open to the objection that they would portray enormous increases in the dollar value of existing fixed properties still in use, and thus lead to claims that "capital accumulation" by large corporation is even greater than ordinary accounting represents it to be. This would be far from serving the purpose of those who feel constrained to emphasize the straitened liquid capital position which many enterprises experience during inflation. It is debatable whether business can succeed in magnifying the size of the cake which has been consumed without acknowledging the corresponding growth of what remains. The business-man's point is, of course, that he's a bigger boy now and has to eat more cake to keep healthy.

Despite the validity of the arguments for recognizing higher replacement costs in discussions of profits, and despite the obvious inadequacy of stated profits to generate sufficient capital for industrial needs, there is still some doubt as to the critical nature of the issue from the accounting viewpoint. There are several somewhat neglected aspects of the situation which suggest that the problem is not quite so serious as is sometimes claimed, and that it will shortly solve itself if accountants can successfully postpone any drastic action.

First, it may be noted that the significance of depreciation costs varies widely among industries, and that in numerous lines of business neither the amount or the cyclical variation of replacement costs is a serious factor. In many industries, fixed asset depreciation is such a minor element in costs that doubling the amount would have no major influence on stated profits. In others, the fixed assets used are mainly of short life, and automatically renewed in large part within a few years, so that the cost of new acquisitions quickly finds its way into increased depreciation charges. Some industries even write off most replacements currently at all times, thus escaping the problem entirely.

The transportation, power, and communication industries have a serious problem, which presumably will have recognition from rate-making authorities. The extractive industries have some relief through depletion allowances based on income rather than initial costs. The heavy manufacturing industries are in the most acute difficulty, being unable to persuade the public or their workers that profits are unavailable for either taxes or increased wages when required for restoration of enormously expensive plant facilities. A solution for this limited segment of industry might render adjustments in others unnecessary.

Second, it is noteworthy that in all lines adjustments to higher price levels occur with considerable rapidity. While the subject is still being debated much of the necessary adjustment has already occurred. A large percentage of our industrial plant has been constructed (or acquired by new owners) within the past five years or so, and by the middle fifties post-war costs will dominate depreciation charges. Meantime prices have begun to decline, reducing the disparity between today's costs and those of pre-war years, and bringing nearer the day when depreciation based on actual costs may look uncomfortably high rather than disturbingly low.

Third, it is worth remembering that the equities in business enterprises are not all of an "ownership" character, expanding and contracting with profit realizations and opportunities. The interests of bond and mortgage holders and other leaders, like those of insurance policy holders and bank depositors, are expressed in dollar terms, and significant only in those terms. If a business earns a specified number of dollars it can pay its interest and principal charges, and need not concern itself with what those dollars will purchase in the hands of the recipients.

This is the one reason why an accounting in money terms remains a most important function of business enterprise and those who keep its records and make its reports. Human thinking about income and capital is in dollars, and people expect to find financial facts expressed that way. Dollars may gain or lose value, but they are still dollars and contractual obligations of all kinds are so stated. The debtor, the banker, and the insurer all promise to pay in dollars, and recognize no other obligation. It is even arguable that the stewardship of the corporation manager extends no further than to preserve the dollar capital entrusted to him, and make it earn as much as it will.

Finally, it is plain that no possible adjustment of income charges to reflect the higher replacement costs of any particular year will cumulatively produce a balance sheet position which gives recognition to whatever price level may prevail at the year-end. To meet both requirements a double set of adjustments must be made—one for the income statement and another for the balance sheet. Analysis of owners' net worth in terms of accumulated profits over a period of years would become impossible—in fact we would be back close to single-entry bookkeeping, with the intervals between statements kaleidoscope of shifting, hypothttical costs and revenues. Our highly-refined procedures for tracing and assigning costs would become meaningless and superfluous.

This certainly is not the situation which advocates of current costs would like to create. They might well consider whether the remedy for wrong infererences drawn from accounting statements is not better interpretation of existing data rather than revision of established procedures. Accountants could do far better in explaining the significance of their statements, and in so doing would eliminate many of the demands that the statements be changed.

The basic problem is rather simple. People want wages high so they can spend more on their living, and taxes on business high so they can have more done for them by the government. They regard profit as an exaction by the greedy rich, and think it should be reduced or eliminated.

It is doubtful whether accounting devices to make profits look smaller (because they won't go as far as they did) will be very useful in correcting this condition. People will have to get a better understanding of the nature, the function, and the disposition of profits, as well as their amount, before they will develop a sound attitude on the subject.

Profits are the excess of the value the public puts on goods and services over what it costs to produce them. Consumers, not capitalists, have the most to say about the size of profits. Efficient management can increase them, by eliminating waste and maximizing production, but the public evaluation of the worth of the product is the chief determinant of the profit it will earn.

Profits stimulate investment in the plant facilities needed to produce more of the goods the public indicates it wants, at progressively lower costs. When profits are restricted, or taxed away, less expansion capital is generated and fewer investors will save for the purchase of business equities. When people spend instead of saving, sources of funds for plant improvements dry up, progress slackens, and human wants go unsatisfied.

Profits go mainly into re-investment in productive facilities, either directly through the action of management, or indirectly through the savings of those who receive dividends. The major beneficiaries are the consumers of the goods which these facilities produce. Stockholders are not chiefly rich folk who use their dividends for extravagant living, but ordinary citizens with a little capital laid by in the hope of an increased future income to compensate for the sacrifice of immediate satisfaction of some present material want.

When people want more goods, they must save to provide the tools required to increase production. Saving and investment can be voluntary (private enterprise) or compulsory (welfare state). Evidence is ample that everyone prospers under the former system and suffers under the latter. The problem is to perpetuate the good fortune this country has enjoyed through personal liberty and individual initiative.

Profits are adequate only if they provide, directly or indirectly, the capital necessary to keep the system going. For twenty years we have been spending and consuming too much, saving and investing too little. The profit reservoir will not irrigate our industrial crops if we divert it to other uses or dam up its sources. Regardless of amount, profits will go where they are needed and provide what is wanted, if the public will stop trying to reduce them or dissipate them.

If business can learn to explain the nature of profits in these terms, and can interpret their amount according to the function they must perform, there will be less need for changes in the way they are calculated. When accountants become skilled in providing the analyses and comments which will make this possible, their techniques and principles will come in for less criticism.

CHAIRMAN SEIFERT: I am sure that I express the sentiments of everyone here when I say that we are grateful to Mr. Watkins and Mr. Greer for giving so generously of their time and appearing on the opening session of the Diamond Jubilee Institute of Accounting. I know that we have all gotten something worthwhile from the thought-provoking messages they have given us. This is an example of the excellent program which is in store for you during the remainder of the Institute meeting.

THIRD SESSION

FRIDAY, MAY 20, 1949—2:30 P. M.

Deshler-Wallick Hotel

Chairman:

ARTHUR CHILD, *President, Institute of Internal Auditors, Inc.; Canada Packers Ltd., Toronto, Canada*

Address: "Costing Problems Posed by Price Fluctuations"

CLINTON W. BENNETT, *President, National Association of Cost Accountants; Partner, Cooley & Marvin, Boston, Massachusetts*

Address: "Budgeting in Periods of Changes in Prices and Volume"

JAMES B. FENNER, *Treasurer, Electric Auto-Lite Co., Toledo, Ohio*

INTRODUCTORY REMARKS

CHAIRMAN ARTHUR CHILD: It is a pleasure to welcome you to the third session of the Eleventh Annual Institute on Accounting.

As you have noted from the program the foreigner has sneaked into the conference. I should like to express greetings from Canada, and in particular to The Ohio State University in its Diamond Jubilee year, and greetings from the Commerce and Finance Department of the University of Toronto.

The fact that I have come here all the way from Canada is really a tribute to the salesmanship of Hermann Miller. I think that any time Hermann wants to stop teaching and start selling, he can make a great success.

We have a fine program for this afternoon. Our first speaker, Clinton W. Bennett, President of the National Association of Cost Accountants, is widely known in the accounting and industrial management fields. A partner of the firm of Cooley and Marvin, Certified Public Accountants and Management Engineers of Boston, Massachusetts, he entered professional work in 1916, and has been active continuously in his chosen profession since that time. He has lectured on accounting and business topics before numerous business, professional and educational groups throughout the country. He is also a member of the American Society of Mechanical Engineers, the American Institute of Accountants, the Massachusetts Society of Certified Public Accountants, National Society of Professional Engineers. He is a Certified Public Accountant of Massachusetts, New Hampshire and South Carolina; a Registered Professional Engineer in Massachusetts; a past President of the Massachusetts Society of Certified Public Accountants; and has served on a number of committees of the American Institute of Accountants.

A member of NACA almost from its inception, our speaker has served as President of the Association's Boston Chapter, as National Director in charge of Education and Chapters, as Chairman of the Committee on Research and as National Vice President. He has contributed many articles to the *NACA Bulletin* and to other business publications.

It is a great pleasure, indeed, to introduce to you Mr. Clinton W. Bennett. Mr. Bennett.

COSTING PROBLEMS POSED BY PRICE FLUCTUATIONS

By Clinton W. Bennett
President, National Association of Cost Accountants;
Partner, Cooley & Marvin, Boston, Massachusetts

It is a great pleasure to be here. It is a pleasure for many reasons. One is that I feel privileged to have some part in helping Ohio State University to celebrate its Diamond Jubilee, because Ohio State has contributed very greatly in this important field of bettering accounting practice and furthering accounting knowledge. It certainly is an understatement to say that Ohio State has been one of those institutions in the forefront in this most important activity.

I am happy to be here because the universities, the accounting profession, and business have mutual problems. We have mutual interests; the public is looking to us for assistance and guidance, and we in the profession look to you in the universities to help us by providing talented young men who will make contributions to better accounting practices in business generally. And, of course, I am happy to be here because I see in the audience many of my NACA constituents.

According to the program I am supposed to talk to you on "Costing Problems Posed by Price Fluctuations." I am glad the committee specified costing problems, rather than cost problems, because fundamental cost problems as such do not change, but costing problems do change.

I construe the term "costing problems" to mean the application of costs, the use of costs, in the day's work; the application of costs to conditions as we may find them. In considering costing problems, I am going to concentrate entirely on the job we accountants have to do in helping management in the day's work. If I stray a little bit from too technical an application of the subject, it is because I believe, and strongly, that in our cost work, we have a broad area to include—the broad area of all phases of business management and business operations. So I am construing costing problems rather broadly.

In considering costing problems posed by price fluctuations, what are some of the problems that business is up against today? What are the problems that businessmen face? Statistics tell us that wages, prices and profits are, practically speaking, at an all peace time high. All of us know that in many respects prices have receded fairly sharply. Profits are receding in many instances sharply, but the statistics, generally speaking, have not yet caught up with the business facts of life. In some ways, the statistics are in the same condition as many of our accounting reports. They are brought out after the fact.

The Pricing Problem

Business today is facing not only price reductions and falling off in volume, but lay-offs as well. I think it can be said in all fairness, and I think it is something on which we can all agree, that the number one problem facing business generally today is to decide what price tags to hang on its goods. What shall we get for our product? We have only to look at the daily paper to realize the problem business is facing in pricing its merchandise.

We know that one business after another is scaling prices gradually, hoping to find the point at which desired volume will be attracted. To a certain extent business is adrift. Under more nearly normal conditions, prices are arrived at by a combination of the use of competition and of cost; competition, dictating prices that prevail, and cost, telling how the individual business must gear its operations to live within a competitive price system. Today, both of those bets are off, because every business is facing, not only demoralized price conditions, but drastically altered price conditions on the down side.

In the light of this situation, how can we as professional industrial accountants, help meet this most serious number one problem? What kind of costing does business need at this time?

Cost and Volume

I think management needs two very specific things from cost. First, management needs to know the anticipated cost of its products at a given desired volume of output. In other words, management must determine the volume it wants to produce, and then it is the job of the accountant to provide the anticipated costs on that basis. That is the first essential, of course.

Then the next thing that management needs in the way of cost is to know how much can be cut from these anticipated or desired costs before getting into the field of out-of-pocket costs. In other words, at what point must the company stop doing business at a loss in order to try to make a profit? That isn't as facetious as it sounds, because that is the problem that faces many businesses today. How much business must be done at a fixed cost loss to make a profit? In order to determine that, management must know how far it can cut the calculated cost, the anticipated cost, before violating the out-of-pocket cost area.

Now, in order for us to furnish management with this vital information, we must go further in our calculations than the more or less orthodox fixed and variable cost division, which to a certain extent has become traditional. Instead of providing our figures, our costs, in these two divisions, fixed and variable, I think we have to include a third division. It seems to me that in order to meet current conditions, costs must be broken down three ways. First, the out-of-pocket costs; second, the semi-fixed costs; and third, the fixed and sunk costs.

Breakdown of Costs

By out-of-pocket costs, of course, I mean all direct and indirect costs which are directly altered by volume. Direct material, direct labor and all direct-indirect costs which directly go up or down with the production of goods, out-of-pocket costs.

Leaving the second cost element aside for the moment, the third element of fixed or sunk costs should reflect those expenses and costs which are there whether we do business or not. Those include insurance, taxes, depreciation, watchman and fireman salaries, fuel cost, maintenance and all expense or cost that will be incurred regardless of amount of business.

Thus, we have on one extreme the out-of-pocket costs, and on the other, the fixed or sunk costs. There isn't too much we can do about those two classifications of costs, other than exercise normal control, normal supervision, normal executive over-look.

But the middle class, the semi-fixed costs, is the area that is in the danger zone, the area in which management needs and must have constant current information. These semi-fixed costs include all salaries, all manufacturing, administrative and selling expenses and all expenses other than the sunk costs and the out-of-pocket costs that are present and yet are not directly variable by volume.

Incidentally, it might be well for us accountants to remember that we are in the number two class, that we are in the danger zone. So it behooves us to see to it that our work can always be considered in the profit-making category, in the valuable class.

Now, what is management's pricing problem in view of these various costs? Competitive products are being constantly driven down in price; the first impingement is on our profit. Assume that we can't take all the adjustment there. That goes out the window.

The next thing to consider is how much of a contribution can we get from these fixed and sunk costs, the costs that will be there whether we get that order or not? Perhaps we get no contribution.

The next question is how far do we move into the number two area, the area of semi-fixed costs? Then management has to determine whether if it has to move into that semi-fixed number two area, this price situation looks like a continuing one, or whether it is simply a temporary one, or the result of a demoralized market condition. If it looks like the new price is going to be of a continuing nature, then management has to determine what to do with respect to these expenses of the semi-fixed area. These are some of the reasons why I believe management needs and must have its costs determined so as to show this three-way breakdown—the out-of-pocket costs, the semi-fixed costs, and the fixed and sunk costs.

After all, business today is faced in many instances with the question of getting volume in order to keep the wheels going, and of determining the point at which increasing volume ceases to be profitable. That is a very important job that we accountants have to do for management.

I think certain supporting data are necessary in this costing problem, data which every business should have. I am not going to get over into the field of budgets, Mr. Fenner, because following me we are going to have a grand discussion on budgets. I'll simply touch on the point because it is essential to get into this area in order to round out the costing angle.

Burden Budgets

I think every business needs burden budgets set up on several different bases. First, a burden budget on last year's volume of business, if that is indicative of a reasonably hoped for amount of business. What are the costs on that basis? Second, a burden budget on a hoped-for volume of business. Assume, for instance, that a company decides that last year we did two million dollars worth of business and that this year we will do a million and a half. What will we have to do? How far will we have to scale costs? What steps will be necessary in order to get our costs down to this new anticipated volume? To answer these questions we need a burden budget based on the expected volume of business.

Then I think there is a third set of costs which we need, a third burden budget, and that is a burden budget based on the physical volume that we obtained in the last pre-war year. I am sure no business, generally speaking, expects to go back to a pre-war volume, and in suggesting this, I am not acting as a prophet of gloom. I am simply attempting to be realistic, because it is perfectly possible that certain individuals, businesses, or industries may go back to a pre-war physical volume of business, leaving the price basis out.

Every business should have a picture of the sort of a program that will have to be placed in effect if that condition comes about.

As Howard Greer so ably pointed out this morning, this business of advancing and receding prices is a normal condition in this country. That pattern has existed in every war in which we have been engaged since the founding of the republic. The usual pattern has always been that prices go down after a war. As all of us know, in a period of declining prices, prices fall faster than costs. When prices begin to fall, we wonder what to do about it. Then we start adjusting operations. We cut costs, but prices go down some more, and we cut some more costs, and it is like the dog chasing his tail. Prices are always going faster than our costs are going down. That is the pattern that in the past has so often led to bankruptcy.

How much better it would be if management would have in the desk drawer a clear picture of just what would have to be done in order to live within a given volume of business and under the conditions that existed before the inflated situation began. Perhaps they would never have to use it, but I know many instances where a program of that sort is proving very important right now. So I repeat again, I think every management should have a burden budget available now made up on these three bases: one, last year's volume of business; two, the anticipated volume of business as it looks at the moment; and three, the pre-war physical volume of business.

As most of us know, the break-even point has become so high in most companies that a sizable falling off in volume or in prices would have rather serious effects. This kind of a program will help management to realize more rapidly and definitely just what will have to be done in order to get that break-even point in a controllable area.

Mass Purchasing

While we are on this subject, there is one other point I would like to touch upon, a problem that probably will be facing more and more businesses if the volume of business declines seriously. It is the demand from massed purchasing units or large buyers. In bringing up this point, I pass no opinion as to the place in the economic scheme of things filled by the big, massed buying companies or massed buying combinations. That is aside from the point. They undoubtedly fill a proper and useful economic function. But all of us who have had experience with industrial concerns know that, periodically, the medium-sized or small business is approached by a large mass buyer with a proposal to furnish a market for a substantial amount of the company's output at a price. Of course, that is very attractive business. Most of us are lazy. We don't have to work hard to sell that sort of thing.

It is an appealing proposition that sings with the voice of a siren. I do not say that it is good or bad. I simply say that that sort of thing must be approached with adequate costing knowledge. Too often business of that kind is taken without due regard to the effect it has on the cost of the remaining products in the line.

Maybe that is all right, but we ought never to allow our companies to enter into any arrangement of that sort without providing management with the costing effect of that procedure. Once again, it is a question of providing management with the facts, with the information, so that the problem can be met intelligently.

Labor Cost and Control

I think the number two problem that business faces today, and the problem in which we as accountants have a very definite costing problem and a function to perform, is in the field of labor cost and labor control. Too often labor cost is sliding over into the category of fixed or semi-fixed cost. If this tendency proceeds far enough, business is going to have an increasingly difficult problem of keeping cost flexible in periods of fluctuating and, particularly, receding prices.

Of course, all of us know there has been too much emotion and not enough facts in the entire field of labor relations, and too often this most important problem is handled on a horse trading basis without regard to the facts involved. The only way we can maintain a proper balance in this three-way pricing and costing problem, is by having information with respect to labor costs and with respect to labor control that is effective.

We hear much discussion as to what is a fair wage. Nobody knows what a fair wage is unless it is matched in terms of output, measured in terms of productive effort. That is the only way we can determine whether a wage is too high or not. If the product produced at a given wage rate cannot be sold in reasonable volume, and produce a fair return to the owners of the enterprise, then that wage rate is too high. No one can determine these things without cost facts, and there, again, is where we come in.

I think that we, as accountants charged with costing problems, have to provide management with three definite things in the labor-cost area. One, we have to make wider use of effective job evaluation. Secondly, we should make wider and more effective use in industry of the merit-rating system. And, of course, thirdly, we must also have an effective yet simple means of measuring output against wage payments.

Too often job evaluation methods and merit-rating methods are confused. The job evaluation must definitely rate the job as such, irrespective of who performs it. So that once that job is evaluated, the evaluation remains constant, unless the job is changed.

The merit-rating system should rate the man so that the old employee, the valued employee, the employee with other values to the business besides that particular productive job, can be compensated. The combination of job evaluation and merit rating is essential, and will become a definite must if the evil day arrives when it becomes necessary to lay off help. Without a sound, fair, effective merit-rating system, too much emotion, too much guess work, enters into this important job of knowing whom to lay off and whom to retain.

Also, in dealing with labor organizations, unless an effective and sound method of job evaluation and merit rating are available, both sides are at a very great disadvantage in arriving at fair, reasonable and logical bargaining conclusions.

Incentives

While we are on this question of labor we should not overlook the matter of incentives, which enters so strongly into our costing picture. This question of incentives will come particularly to the fore if we are to continue for some time in a period of price recession or price adjustment, and I think it is only reasonable to assume that we may have some months of price fluctuations and price reductions ahead of us in most industries. So the question of incentives will continue to be an important problem with most businesses.

I am not at all sure that much of our incentive work is in the right channel, and I say this with a certain amount of apology, because across the last quarter of a century I have earned quite a bit of such meager income as I have had in installing wage incentive methods. I am not sure that individual incentives are so sound as we once thought they would be.

You say to the man, "Here is a product. For every piece you produce, we will give you so much money." That is all right, and yet I do not think it is the long-range answer, and I hope we accountants and cost accountants are not going to regard it as the last word on incentive methods. You know, to a certain extent, when we put it up to the workers in that way, management is passing along part of the management job.

I am more inclined to believe that we will see more of a return to measured day work. Measured day work is old, as all of us know, but I am not so sure that it is not going to come back to the foreground, coupled with sound methods of output determination, and tied in with the merit-rating system and the job evaluation plan. I think perhaps we will also see more of a switch to over-all incentives; group incentives, rather than the strict individual measurement incentives.

Profit Sharing

There has been much publicity given to so-called profit sharing methods; profit sharing, as well as incentives. I happen to be one of those who do not believe much in profit sharing as a means of incentive, for very practical reasons. In the first place, I do not believe it is effective. Usually, the company pays for something it does not get. I mean this. To have any incentive effective, it must be one that the worker can gear to the day's performance. The further the incentive gets away from the day's work, so the worker can tie up his earnings with the day's effort, the less effective it becomes. So I say I do not believe in profit sharing as a basis of worker reward, because I do not think it is effective.

The second reason I do not think so much of it is that it is too hard to measure and control. In periods of increased business, rising prices, and of course resulting rising profits, it is easy to appropriate a certain amount of anticipated profits. But when the reverse trend takes place, the effort of determining the amount of profits to be distributed and of controlling it becomes very great.

For these two reasons, I think profit sharing as an incentive scheme is not particularly effective, and in my book I just do not like it.

Income Reports for Management Purposes

I am sure there are many of you who disagree with me on some of the statements I have just made. However, there are a few other debatable ideas which I would like to touch upon, if you will bear with me for just a moment longer. One of the important jobs we have in costing is that of clearly stating income for management. I do not mean stating income for purposes of published reports to stockholders or to the financial community. The publications and utterances of committees of the American Institute of Accountants and other learned accounting organizations have very splendidly covered that area in the field of published reports and financial reports. I am thinking, particularly, of clearly stating income for the purpose of management information and management control.

Management needs profit and loss information and needs it quickly, at the end of every month. Such profit and loss statements should be analyzed by major classifications of products, and should be arrived at by pricing shipments at anticipated or standard cost, and not by pricing inventories.

The reason that I think the cost of sales should be arrived at in that manner is that management is using certain costs, whether you call them standard costs or pre-determined cost. Call them what you will, but they are costs prepared on the basis of assumed output. Management is using those costs to measure prices or other factors of cost control, and as a result should measure operating results by using those costs against selling prices. In other words, matching the assumed costs against the sales dollar return, the cost of sales should be arrived at for management's profit and loss statements by pricing shipments at standard cost, and arriving at the profit and loss results from those figures. Then, of course, the cost variances come in there, and the final actual income or loss.

Depreciation

I suppose I should say something about depreciation at this point in our costing problem analysis but this morning Howard Greer covered that very fully indeed. However, I will say that I think for our purpose of costing, depreciation should be taken into consideration on the basis of the values shown by the books. In those industries where depreciation is an important element of cost, I think it is important for management to have available the effect on cost if depreciation were calculated on reproduction values. I certainly would not write it into costs or the accounts, but I do think it is valuable information for management purposes, for control purposes and for use in considering selling prices, if the prices are going the other way.

Cost Variances

Just a word on cost variances in our cost problem. All of you know, of course, that I refer to the differences between anticipated or normal or standard costs and what actually happens when the accounts are cast up at the end of the month. In no instance should the cost variances be allowed to find their way into the cost accounts during the year. At the end of the year, it is another problem. Obviously, they may become a part of cost of sales. If there are variance losses, they should be deducted directly from the profits on the profit and loss statement. If there are variance credits, they should be split between the amount of the variances tied up on goods in inventories and the amount of variance credits that were earned on shipments.

The amount of variance credits earned on shipments will be credited to P and L at the end of the month. The amount earned on manufactured goods still in inventories will be shown as a reserve against inventory. That becomes a very important distinction in periods of expanding business, because the sheer velocity of business might produce and very often has produced variance credits which, if they were credited directly to the P and L would produce profits that would disappear rapidly at the end of the year when the cold blooded auditors come around and apply the principle of lower of cost or market to the inventory.

Too Much Bookkeeping

I think that very often in our cost problems we get tied up with too much bookkeeping. In many respects, the bookkeeping complex has held practical cost accounting back. I say that with due consideration for the importance of having the costs controlled by the financial books. That is essential. Otherwise you have neither fish, fowl nor good red herring.

As a simple illustration, suppose you have your costs on some predetermined basis. You want to know how closely the material, labor and standards are absorbing actuals. You do not need bookkeeping entries to do that. As a matter of fact, all you need to do is take straight from the trial balance all the burden amounts for the period, and to compare the result with the amount of burden absorbed at the standard rates. The same may be done for labor. The labor absorbed against the direct labor, or the material absorbed against the actual material cost used. If you want to run those entries through the books, well and good, but in many cases of small companies, we frighten the small business man with the bookkeeping involved. Very often we accountants could be of substantial assistance to him by providing him with standards of performance, reasonable standard costs, and practical methods of accounting control without too much of the bookkeeping influence.

I would suggest to our good friends, the accounting instructors, our good friends the professors, that here is an angle that could well be considered in teaching, in pointing out to accounting students the importance of getting across accounting information under given circumstances, that we cannot lay down hard and fast rules of cost control and costing determination applicable to all businesses. I am sure that all the instructors at Ohio State University do this, but it is sometimes well to restate some of these.

Social Implications

Finally, we must never forget the social aspect of our work. It is particularly important now, because our costing concepts may have far reaching effects. Unsound costing concepts, unsound methods of price determination may well help to price our companies, our clients' companies, out of the market. We may, by unsound costing and pricing methods, upset instead of help balance the delicate position that exists and must always exist between wages, prices and profits. After all, the first job of business—and we are part of the business community as costing and accounting advisors for the business community—is to serve the public. This means that business must constantly strive to get more goods to more people at the lowest possible prices.

Business has a second job, one that is expected by the public, and that is to provide to the greatest extent possible, a job for every man who wants one, at the highest possible wage. After all, it isn't what we think of business that counts; it is what the man in the street thinks—the man who has not had the benefit of our close association with business, who does not understand the problems, yet the man who is going to decide what happpens to business. This public attitude is going to depend on the job that business does in meeting these two fundamental and most important problems. After all, since time began, man has struggled to produce the things that he needs, and wants, and now for the first time in recorded history we have an industrial system that is capable of doing it. But we have to find means of making it effective.

In that important job, we accountants have a tremendous opportunity, but we also have an equal responsibility.

CHAIRMAN CHILD: Our next speaker was born in New Jersey, educated in the public schools of New York City, and after World War I, served with Price, Waterhouse and Company for eight years. Since 1927, he has been Treasurer, first of the subsidiary company, Prest-O-Lite Battery Company and later of the Electric Auto-Lite Company, which position he now holds.

He is a member of the American Institute of Accountants, and a past President of the Toledo Chapter of NACA, as well as of the Toledo Control of the Controllers Institute of America. He holds a CPA certificate from Indiana, and a law degree from the Benjamin Harrison Law School of Indianapolis.

It is a pleasure to introduce to you Mr. J. B. Fenner, who will speak on "Budgeting in Periods of Changes in Prices and Volume." Mr. Fenner.

BUDGETING IN PERIODS OF CHANGES IN PRICES AND VOLUME

By James B. Fenner
Treasurer, Electric Auto-Lite Company, Toledo, Ohio

For the benefit of those who will have only a few minutes to glance at these proceedings or who found it impossible to attend the meetings in Columbus, I should like to summarize in a few paragraphs the major points covered.

1. Falling prices mean keen competition, which in turn means closer attention to all expense items entering into the cost of both manufacturing and selling the product. Budgeting is one of the best means of keeping these expenses in line.

2. Budgeting is necessary for the follow-up of comparison between actual performance and the predicted desirable. It is the best tool that management can use in determining that the business is going steadily toward the right objective or profitable operating results. Budgets, in other words, take the guess work out of managerial understanding of what is going on.

3. Keener competition usually leads to greater efforts in securing sufficient volume to maintain favorable overhead costs. Proper budgeting will guard against disproportionate expenses such as overtime, excess labor, idle time, and other nonproductive costs which may creep in if production is not budgeted and kept in step with sales. Budgeting also keeps tab on selling expenses through the sales budgets and bonus plans.

4. Budgeting keeps the expansion program in step with present sales volume as well as estimated future requirements. This guards against loss of customers' goodwill, which might be caused by failure to deliver merchandise when and as ordered.

5. Cash budgets serve to keep the financial operations within the proper limits. Cash is the life-blood of any business, and it must be properly conserved and utilized to its maximum productive ability in order to keep the business strong in meeting any emergency which in times of declining prices and low volume may be quite serious.

6. Budgeting points up management's role through its supervisory force, and focuses attention on the important matters that should be discussed and acted upon at frequent intervals, say weekly or monthly as the business

progresses. The budget offers something tangible to talk about and gives reason to praise, blame, or otherwise criticize the people responsible for results.

7. Budgeting should not degenerate into a straitjacket system of restricting necessary or desirable expenditures. It should, rather, focus attention on the necessary things, and weed out the useless costs of doing business.

The president of the C & O Railway Company summarized his 1948 annual report by stating that "Our future lies in greater efficiency in operations and substantial reductions in expenses. Plans for realizing these objectives are well under way." These comments apply to every business that wants to stay in the march of progress which characterizes American industry in general. It is especially true in times like the present, and the right kind of planning through budgets will help a lot in achieving our aims for success.

Budgetary Control in General

One of the popular radio programs of late has been one in which Bob Trout leads off with the interrogation, "Who Said That?" As an introduction to some of my remarks, I thought it would be well to quote the preface of a very authoritative book on Business Budgeting and Control, and see how many in the audience can trace its authorship. If you have not read this book, I sincerely hope that this introduction will challenge your interest enough to get a copy and read not only the part quoted below, but as much of the text as fits your particular needs.

The quotation follows:

> "The challenge presented to American business leadership at this time is perhaps unparalleled in all industrial history. To meet this challenge, two basic responsibilities must be accepted. First, business leadership at large must accept and make effective the principle that social responsibility transcends the selfish interest of the individual business concern—its management and controlling owners. This is no mere platitude; it is fundamental to the very existence of free enterprise. Through intelligent planning the cycles of industrial activity must be made less severe, regularity and security of employment must be provided for all deserving workers, and there must be a far greater refinement in the mechanism of providing incentives for individual effort and in the reward of individual merit. The maintenance of free enterprise depends far more upon industry's ability to provide regular employment and opportunity to the rank and file of deserving workers than upon supplying a dead level of subsistence to both deserving and undeserving. Second, both management and workers must increase their skills. Operations must be better planned and more expertly directed; wastes of time and materials must be reduced in the face of more intensive world-wide

competition. It is industrial efficiency rather than legislation that will ultimately provide shorter working hours and a higher standard of living.

But the whole industry will be no better than its parts. The individual business must be better planned and more efficiently organized and operated if the whole of American industry is to continue its forward progress. . . . .[1]

I have read and reread Professor Heckert's book in the preparation of this paper, not only because it is very interesting and valuable reading, but also for the reason that I did not seek to pioneer any new, untried theories. I would rather be very sure of meeting the standards of the university which is the host for this meeting. Furthermore, if I have said anything contrary to this book, I know that I will have to defend it in the question and answer period that follows, and that surely would be tough, knowing as I do, the astute accounting minds gathered here today.

No, there is nothing new about budgeting techniques as far as this paper will reveal, but we are living in a new day as far as the application of budgetary principles is concerned. It is toward this phase of our subject that I wish to direct your attention in the short space of time allotted to the subject. My approach has been influenced by another excellent book entitled *Budgeting Control*, published 29 years ago by Ronald Press. The writer of this book was James O. McKinsey, A.M., LL.B. of the University of Chicago. The principles expounded then are just as true today.

During recent months, I have also been very much interested, from a budgeting viewpoint, in early morning broadcasts on the radio which are apparently calculated to influence the thinking of the farming element to which they are directed. For instance, a broadcast recently referred to a farmer by the name of Woodrow Wilson, living in Monroeville, Indiana, who had purchased a run-down farm of about 160 acres and yielding about 40 bushel of corn to the acre when he took over ownership. In a couple of years, after planning and *budgeting* his operations, the yield had increased to 80 bushel per acre. This farmer who was talking directly to an interviewer on his farm, mentioned such things as overhead, labor costs, fertilizer expense, machine upkeep, just like we would expect to hear a foreman in the shop talk to a cost accountant about these things. It was easy to understand that after putting into effect important changes such as rotation of crops, proper fertilizing, and all the other essentials that go into successful farming in these times, that the 100 per cent increase in yield was not a mere accident. It was interesting to note, also, that the cost of doing business in a profitable way was less than what it would cost to do it

[1] Quoted from the Preface of *Business Budgeting and Control*, by J. Brooks Heckert, A. M., Com. D. Published by the Ronald Press Company—Copyright 1946.

unprofitably, and the natural effect on anybody listening to the radio broadcast was to arrive at the conclusion that hit-or-miss methods of farming were no longer good business if the operation was to show satisfactory profits, and I notice the farmer did mention the word "profits."

We should likewise feel in our approach to manufacturing or other business budgeting that our real objective is to point out deficiencies in our operating scheme of things, and bring to light expenditures which fail to result in an improvement in our operating results, rather than merely to make of our budgeting performance a needless heckling and nagging at the various levels of management on a morale busting basis. In other words, our efforts should be directed to the proper interpretation of the figures so that corrective action can be taken by those responsible for performance of the plant, office, the sales department, or whatever division of the business is being measured by our particular budget layout. In this way, we can secure the hearty cooperation of those we are dealing with, because every normal person wants to show better profits in that they measure better efficiency and performance, thus reflecting credit on the performance.

My point in bringing in the true story about the farmer is to illustrate how far-fetched budgeting has become in this day of highly developed business in all of its manifold phases.

Political units have had their share of headaches lately over budgets, but that is a field in itself. After all, a political unit seldom goes bankrupt because taxation is considered limitless, and the forces of competition are not present. In comments made by ex-president Herbert Hoover before a congressional committee on April 11, 1949, it was stated that antiquated budgetary controls over armed forces made it impossible for the Congress to control expenses, or to find out later where the money spent on preparedness really went. What a tragedy in handling vital fiscal matters!

Budgeting as an Aid to Earning Profits

We hear nowadays a great deal of talk about profits not only from the proprietors or the management of a business enterprise, but also from labor circles, farmers, and others. Why not? Profits are the mainsprings that make the wheels of a successful enterprise go around. When we speak of budgets, I say again that we should bear in mind that, in its broadest sense, budgeting is not just a strait jacket into which we try to compress all expenses. It is, rather, an intelligent control factor with which we seek intelligently to measure income as well as expenses, so as to keep both within the proper bounds of sound business management and come up with a profit to the business.

It is an old axiom, and a true one, that to make money, we must spend money, and budgeting, therefore, should not degenerate into a pinch penny system of trying to curtail the necessary flow of the life-blood of a business represented by such things as advertising, maintenance of properties, engineering, development of new and better products, and all the other activities which go to make up a successful enterprise.

We should keep in mind that most businesses, like healthy children, have to grow up by gradual stages, and when we budget our cash, for example, we should make it a point to keep all expenditures, no matter how necessary or desirable, within the capacity of our incoming cash to defray expenses. Many a business has gone bankrupt on the theory that they could spend more than they would earn, just so long as the money went for worthy purposes. If they had used a budgetary system, many of those businesses could have avoided the rocks and steered a more conservative course until they accumulated sufficient financial strength to reach out into new and larger fields of action. Most blue chip companies in our country today delight in boasting of their early beginnings in obscurity and their growth over succeeding years. In this steady progress, budget usually plays a very important part.

Budgeting might also be compared with an overdose of vitamins which sometimes has just as bad an effect on a patient as an underdose, or no dose at all. The human body can consume only just so much at a time, and a well-budgeted business is one which measures operations within proper bounds. Too much sales volume can sometimes be as bad as too little when it means taking on shaky credit risks, unprofitable lines of merchandise, or an overextended financial expansion program. The reaction may be contrary to what was expected at the outset—namely, a profitable venture.

Budgetary Control Applied to Specific Functions

All these entanglements can best be avoided by a system of budgetary control which may include all, or, in some cases, only part of the following:

1. Sales budget for the current fiscal period showing:
   a. Breakdown by main classes of sales
   b. Expected volume in each sales territory
   c. Monthly totals to bring out seasonal variations between actual versus estimated sales

2. Production budget to show:
    a. Monthly sales of each plant or manufacturing unit used in producing products required under 1
    b. Estimated manufacturing expenses each month necessary to carry out production program within profitable limits
    c. Plant expansion required to establish productive capacity called for under 1
3. Purchasing budget (tied in with inventory control plans)
4. Advertising and sales promotion budget
5. Cash budget

In a paper of this kind, it will be impossible to go into the subject of what each of the various budgets under the five classifications would probably include, or how they may be eliminated in the average business. That can best be taken care of by reference to available text books, two of which I have already referred to in my remarks. I can in this space, however, build up some concept of the important and proper application of these budgetary tools of management in connection with maintaining prices and profits in this period of rapid change. I will take them up in the order listed above.

Sales Budget

No business gets very far unless it has a long-range view of where the enterprise is going, coupled with a series of short-range viewpoints, as to where the business is to come from, and, as time goes on, whether or not the plans have been accomplished in every particular.

If the business has been in operation any length of time, it should be easier than in the case of a new enterprise just starting up to determine with reasonable accuracy what the sales volume can be expected to reach. In an old established business, the amount of sales usually can be very accurately measured in its seasonable trends, and in its over-all trend, provided the underlying facts and figures have been carefully maintained over prior periods. In wildly fluctuating times, however, the job is no easy task. Under such circumstances, the combined knowledge of all managerial personnel must be called on for super-guidance in any budgetary plan.

It should be mentioned, in this connection, that the number of outlets, dealers, distribution points, or whatever else determines the consumption of a given product, is a basic factor in setting up these budget desirables. Usually, the sales manager will have a very good idea of what a given distributor or customer can accomplish for the months ahead, because he has found out through correspondence, personal contact, and the information gleaned by his sales contact men, just about what can be expected from a given territory. I am making this important point at this juncture because no budget, whether it is sales production, finance, or whatever else one is talking about, can be very much unless it is prepared under the direct supervision of men qualified by knowledge and experience and having proper supporting staffs to guarantee accuracy, completeness, and intelligent application. In other words, there is no formula to take the place of intelligent management.

Breakdown by Main Classes of Sales—The breakdown under classes of sales is quite important because the margin of profit may vary considerably with a given class of commodities, or even with items within the same class. Here is where the keenest kind of cooperation between the sales and accounting, engineering and all other allied departments must come to the front. If a given item is failing to show a reasonable profit, the budget preparation should bring that out and then steps should be taken to find out what possible means may be used to reduce the cost, raise the price, or, as the last resort, eliminate the item entirely from the line. Many a business has gone along for years thinking it was making money on a given class of products, only to wake up one fine day when an intelligent analysis was made of sales, to find that one or more items were sapping the life-blood of the business, and that the real profits were being made on items that should have been pushed upward while the losing items should have been eliminated or corrected in some way. This determination of profit on sales by main classes is quite important, because at this juncture of the budget preparation, we arrive at the gross profit estimate with which to finance advertising, sales force, and all other auxiliary requirements that go to make up a successful sales program.

Expected Sales Volume in Each Sales Territory—Sales volume classified by territories is of the utmost importance in preparing a sales budget where the business reaches out over a territory of any size. It is not uncommon, particularly in these times, to find that points far distant from the place of manufacture are money-losers when transportation costs and other expenses are considered. In a sparsely settled territory where outlets are few and far between, it may be well to cut out the territory entirely rather than to throw money away in a profitless effort to bring in sufficient volume to carry the overhead. In a company doing business on a national scale and guaranteeing service from coast to coast on a product such as automobiles, it is not possible to eliminate territories in this manner because the motorists will require attention to his car no matter where he needs such service. On certain other items, however, such as kitchen gadgets, the local consumer is not dependent on nation-wide service, but can use one product as well as another. The territorial analysis used in building up the expanded budget may indicate that there is nothing to be gained, and everything to be lost in carrying on operations in such places.

Monthly Totals to Check Actual Versus Estimated Sales—The above remarks have no importance unless we can begin measuring our actual results against the budgetary desirable as the business moves along over the fiscal year. It is assumed that after the budget has been prepared and approved for a fiscal period, it will be broken down into months for convenience and comparison with period reports coinciding with the usual report rendering. The actual results may be measured against the budgetary desirable if we are to benefit from all the work of preparation which was required in planning what the business was expected to accomplish. It is very interesting to watch the variations month by month, and very profitable to the management to know just where the course of the ship of business is leading them. If the sales are not holding up with the budget, it may then be necessary to make some corrections in the expense, always bearing in mind that a desirable profit is what we are in business for. In some political setups, perhaps it is not a profit as such, but at least a break-even point, but in any event, the real value of a sales budget lies in knowing how the actual progress ties in with the forecast or budgetary setup at the beginning of the race. This method of measuring performance is often tied in with a reward system such as a bonus payment to salesmen for accomplishing the budgetary goal over the period. Naturally, any salesman who is not earning his bonus is a target for either corrective measures or dismissal, because he will be a loss to the business if he fails to measure up to expectancy. In any event, the budget will focus the sales manager's attention on that particular salesman and on the territory where business is not panning out in a way that means success to the employer as well as to the employee. Like a cancer, it must be knifed out unless the disease is to be allowed to spread and cause more serious consequences.

PRODUCTION BUDGET

Keeping Production in Step with Sales Performance—Whether it is one plant or a dozen plants, each unit involved in producing to meet the sales estimates in the sales budget, must be carefully sized up from the viewpoint of its production potentialities, and as to whether enough business can be put into that manufacturing unit to operate it profitably. The plant must have sufficient business to earn its overhead, but not an excessive amount which might easily turn the operation into a nightmare, and even interfere with the delivery of the production which the Sales Department has produced. It is a very serious matter not to produce so as to keep step with sales because it not only interferes with profits, but it undermines morale of the sales force and of the customers involved as well. This is one of the most delicate features to forestall in a manufacturing unit and one which must be carefully planned if repercussions that will be distasteful to everybody concerned are to be avoided.

Over a period of years, the average business will show growth as its products are consumed in ever-increasing quantities, and the successful management is the one which, through budgetary control, is able to foresee those requirements and prepare its manufacturing facilities accordingly. It may be just as serious to over-expand as to under-expand, but the only proper expansion will be that which will keep production in step with the sales performance.

Monthly Budget of Manufacturing Expenses—After the production requirements of the unit have been lined up with the sales program, the next step is to budget the expenses month by month to make sure that the actual expenses over the operating period are kept in line with the budgetary desirable.

Here as in the case of the sales budget, a business with past experience has an advantage, ordinarily, because the budget can be based on what was actually accomplished over a reasonable period in the past. By reasonable period, we naturally include one where volume was up to normal and no unusual obstacle interfered with orderly production. Any budgetary desirable in terms of expense to direct labor or machine time or whatever other factor is involved, must be a figure that is reasonable of accomplishment. After all, the supervisory forces of the plant, including the foremen as well as higher executives, cannot live with a budget that does not offer them a reasonable program to accept. Nothing causes contempt quicker than an unreasonable forecast, or an unfair presentation of figures in regard to the actual results. At this point, I would like to bring out for the benefit of those who plan to be accountants, that accounting skill in working out the figures is put to a supreme test, in my opinion, when it comes to budgeting. One reason I say that is because it requires not only technical skill, but also good horse sense. The latter is one of the rarest attributes to find among accountants, and, for that matter, among citizens in general, so do not be offended. I merely wish to point out that all the figures in the world will not convince a hard-boiled production man that he ought to hit one per cent of direct labor in his spoilage and waste expenses, if, after putting forth his best efforts, he has been experiencing five per cent over a long period of time. If you are going to slap him in the face with one per cent, then you should be prepared to back it up with basic facts. It should also be remembered that false goals for attainment may discourage an energetic and ambitious foreman, because he never gets a pat on the back for hitting the bull's-eye. The budget should be set up so as to provide for the possibility of hitting 100 per cent accomplishment after hard work.

Plant Expansion—I have already touched on this subject and I think that this is a matter for each individual company or unit to work out for themselves using the experience of the past, coupled with complete knowledge of what they face in the future, before going ahead with any program.

PURCHASING BUDGET

We have gone through a recent period of price change, and on a downward trend such as has been experienced in most cases, the Purchasing Department has become a vital factor in controlling our inventories.

Whether your Purchasing Department or your Planning Department or both have the say-so, it would be well to have their activities budgeted in line with the sales expectancy. There may be some good reason for accumulating a larger stock of merchandise than is needed for the moment, but ordinarily that would not be the case on a declining market where the trend over a period seems to be downward, as it has been recently. Purchasing comes under pressure immediately, under any sound budgetary system, to restrict its buying to the lowest possible point. This not only protects against losses through price declines, but conserves the cash, building up the working capital to a sufficient strength for whatever may be ahead.

It is easy to see that unless the sales estimates are carefully prepared ahead, both as to long-range and short-range, the Purchasing Departmtnt is bound to go off the beam. The planning department, working with purchasing, must bring in the merchandise in a manufacturing establishment far enough ahead to have it on the production line where it is needed, and at the time it is needed. They have no choice other than to follow the leadership of the Sales Department. That is why I have tried to point out all through this paper that the keystone of the arch is, in most cases, the sales budget, and that if that fails, the whole structure falls in ruins.

ADVERTISING AND SALES PROMOTION BUDGET

An outstanding point brought out in Dr. Heckert's book is that advertising and other auxiliary sales expense should be based on sales. Nothing more truthful could be said, in my opinion.

There is not much point in advertising a product that cannot be manufactured in sufficient quantities to satisfy the market created by such advertising and sales promotion as is expended on it. I remember a case in World War I where the management of certain food product spent a huge sum of money rather than pay income taxes which were high at that time, and the figures later showed that the money was thrown away as far as producing additional sales was concerned. I do not think that was an isolated case, and probably some of you have seen similar performances in your experiences.

CASH BUDGET

Cash budgets like all the rest of them hinge on sales. The first figure we like to deal with in preparing a cash budget is the amount of money we collected from customers, and we can't talk in terms of customers unless we know what the Sales Department is going to charge up on the receivable ledgers.

The disbursements can be estimated closely with the possible exception of the purchases of manufacturing material. The trouble in that connection is that the purchase budget shows transactions on an accrual basis, and when we are talking about cash budgets for a limited period, we are not interested in what is being bought, but what is being paid for during that same period. These things can be worked out in the average business, particularly if they have some past experience to go on, and in a limited paper of this kind, it cannot be covered adequately except to mention that the cash budget is a desirable arrangement to focus attention on the need for current capital, and to bring about whatever means are possible to accomplish that end.

Technique of Interpreting the Budgets to the Various Managetial Persons Involved

TERMINOLOGY AND SUPPORTING DATA

Budgetary figures are such that they are not of much importance to men outside of the field of accountancy, unless clearly interpreted. For this reason, we have to think in terms of production men, salesmen, engineers, and others in the various fields of operation affecting a given business when we present budgetary reports.

For instance, if we are going to discuss the figures pertaining to plant operations before a foremen's meeting or one individual foreman, we must be careful not only of our terminology, but also of the supporting details which go to make up the figures. The foreman will soon get to know what you mean by scrap, spoiled work, defective material, or whatever other terms are used in your particular accounting system to describe failure to produce standard or salable products. The important point is to make sure that your terms are understood before you get too far afield in an explanation of some particular point in the budget. Equally important with terminology is the ability to support your statements with easily understood facts and figures. For instance, if you are talking about scrap, you should be able to support your figures with a written record of the inspector's rejects for a given day and operation by a specific operator so that the foreman knows just where to put his finger on the trouble. Likewise, repairs to machines should be so analyzed as to bring out from the property records, the types of machines repaired, ones that were repaired previously, and all the facts that can be obtained from the work order and other supporting records. In this way, the foreman or other supervisors involved have an intelligent background to work on, and we are more likely to arrive at a prompt and sensible answer to the problem.

Sales expenses have to be broken down the same way. Sales executives are usually trained to analyze their activities to the point where they know what material salesman are selling, and how much of it, so if you are analyzing expenses, you must likewise get down to a specific salesman and territory when you begin to criticize excessive operating costs over the budget desirable.

Comparisons with prior periods as well as budgetary desirables are always beneficial in gaining a prospectus as to what is going on currently. For this reason, your reports should bring out from time to time the percentage of expenses this period to sales or other basic measuring factors as compared to what they were at some prior period. This is where your accounting training comes in, and it is well to remember the following tricks of the trade when you are talking shop with men who are not primarily interested with the accounting side of it:

1. Purpose of group meetings to discuss the budget.
2. Purpose of budget conferences with individuals.
3. Control charts and statistical statements.
4. Audits and reviews.

Purpose of Group Meetings—The mere preparation of accounting facts and figures is not the final word in good budgeting. The next job is to sell those figures to the people responsible for operations so that the management, as well as the people doing the direct supervisory work, can understand fully just what matters should be corrected.

A budget meeting where a group of foremen are present rather than just the foremen of given department helps to focus attention on general problems, and builds up a better over-all understanding on the part of supervisory force as to what problems have to be met. For instance, a shortage of work that happens to hit the first processing department will sooner or later affect all the other processing departments, and it would be well, therefore, to have this situation discussed as soon as possible in order to make plans for meeting the reduced schedules.

Another good point about having all the men together at frequent intervals is that it presents an opportunity for management to discuss other matters than just what are tied up definitely with the budgetary controls. This may include future production schedules, changes in plant layout, new customers coming in, new products to be taken care of, union grievances, general welfare plans for employees, and a host of other things that are of general importance.

From the accountant's angle, the discussion of figures at budget meetings gives him a better perspective and a truer understanding of what is going on in the plant. Sometimes it is rather hard to understand such things when an accountant does not have access to the manufacturing problems through conversations with the men directly involved.

Individual Conferences—The group meeting should be supplemented by individual contacts with foremen or other individuals directly concerned with a given budgetary situation. This means getting right down into the detail concerning any given budgetary excess such as scrap, excess labor or what-not. In so doing, the accountant is quickly brought back on the beam in the event that his source information is being served up incorrectly. The element of time is very essential in this connection. Once a week is not too often to check manufacturing expenses, at least those expenses that are out of line with the desirable. The time may be once a month in the case of sales budget, because it is not always feasible to compare at more frequent intervals unless the situation is one that is rapidly changing every week, and that is not ordinarily the case.

Control Charts and Statistical Statements—Some visual exhibit which could be hung up on the wall in the plant manager's office is a good form of visual education, particularly if it is kept right up to the minute where all can see it and grasp the picture as to what is going on in the way of efficiency.

Comparative statistics over other periods of similar operating conditions are valuable guides to the management in knowing just where they stand on some such comparative basis.

Audits and Reviews—The budget should not be taken for granted and left to routine clerical handling with the theory that it will run itself.

Frequent reviews and audits should be made by the budget director by testing samples of the departmental reports as well as the over-all performance sheets. This will give him more intimate knowledge of what is going on, and will reveal any flaws in performance that may have escaped those preparing the figures.

Periodical reviews of budgetary procedures and early recognition of necessary alterations in forms, procedures, etc., are necessary if the budget is to be kept up to date and serve its true purpose of reporting changes from desirable results in the operations which it measures in these times of changing prices and volume.

Appendix

Samples of charts used in measuring weekly performance in a manufacturing plant are made a part of this report as Exhibits I, II, III, and IV. A unique feature of these exhibits is that the budgets go far beyond the usual measurement of manufacturing expenses against their pre-determined standard.

Exhibit I Cites data of a variegated nature to bring out to the management certain salient features entering into the accomplishments. One of the real important points to these budgets is that they are prepared weekly, thus keeping a firm hand on the throttle.

Exhibit II Measures all items of manufacturing expenses weekly in their relation to direct labor.

Exhibit III Measures the controllable expenses in productive departments for discussion with foremen weekly.

Exhibit IV Measures expenses monthly for each department showing in addition to items on Exhibit III, all items of expense whether controllable by the foreman or not.

EXHIBIT I

Company or Division

PLANT CONTROL SUMMARY

PERIOD ____________

MANUFACTURING PERFORMANCE	Period	Year to Date
Departmental Efficiency	%	%
Plant Efficiency	%	%
Loss—Failure to Perform at 100 % Departmentally		
Direct Labor Produced per Man Hour Worked (Ideal $)		

PRODUCTION COST ANALYSIS	Period	%	Year to Date	%
Finished Production Cost				
Material				
Labor				
Burden				
Total		100.0%		100.0%
Material Variance and Freight (see reverse side)				
Burden Loss (See Series II)				
Total Finished Production Cost				

INVENTORY ANALYSIS	Balance January 1	Balance End of Period	Increase or (Decrease) Period	Increase or (Decrease) Year to Date
Raw Material				
Work in Process—Material				
" " " Labor				
" " " Burden				
Finished Goods				
Supplies				
Total Inventories				
Inventory Turnover:	Actual		Desirable	

HOURLY PAYROLL DATA		Period	%	Year to Date	%
Direct Labor Produced					
Indirect Labor Incurred					
Total	(a)		100.0%		100.0%
Vacation Pay Paid			—		—
Holiday Pay Paid			—		—
Retroactive Pay Paid			—	(Include Above)	—
Total Hourly Payroll			—		—
Number of Man Hours Worked	(b)		—		—
Average Rate per Man Hour	(a ÷ b)		—		—
Overtime Hours Worked			—		—

	Male	Female	Period Total	Male	Female	Year to Date Av
No. of Employees						

GENERAL DATA	Period	Year to Date
Production in Sales Dollars		
Profit and Loss Performance		
Plant Commitments (See Reverse Side)		
Days Worked		

ANALYSIS OF MATERIAL VARIANCE AND FREIGHT

Classification	Period		Year To Date	
Purchases from Affiliates				
Total Material Price Variance (Acc't. 3101)				
Freight on Material (Acc't. 3102)				
Demurrage (Acc't. 3102)				
Usage Variance (Acc't. 3105)				
Total Material Variance and Freight				

ANALYSIS OF PLANT COMMITMENTS

Classification	Period		To Date	
A—Productive Materials and Inventory Supplies				
B—Equipment, Tools, Dies, Molds, Furniture				
C—Material for Building Construction and Repairs				
D—Advertising (All Types)				
E—All Others				
Total				

EXHIBIT II

_______________________________ Company or Division

_______________________________ Department

ANALYSIS OF PLANT BURDEN

PERIOD ENDED_______________

	AMOUNT			% to Direct Labor		
		ACTUAL		Desir-	ACTUAL	
	Desirable	Period	Year To Date	able	Period	To Date
Supervision................						
*Non-Productive Clerical......						
Indirect Labor..............						
Excess Labor...............						
Reoperation Labor..........						
Set-Up Labor...............						
Inspection Labor............						
Material Handling...........						
Downtime..................						
Overtime..................						
Night Bonus................						
Checkers and Time Clerks.....						
Vacation Wages............						
Holiday Wages.............						
Supplies Used..............						
Spoilage and Waste........						
Repairs and Maintenance:						
Machinery & Equipment....						
Dies, Tools and Molds......						
Plating, Polishing Fixtures...						
Shop Trucks.............						
Automobiles and Trucks.....						
Recharging Batteries.........						
Power Consumed...........						
Gas Consumed.............						
Air Consumed..............						
Water Consumed...........						
Steam Consumed...........						
Depreciation...............						
Rent, Light and Heat.........						
Taxes.....................						
Insurance..................						
Rental Expense.............						
Social Security Taxes........						
Compensation Insurance......						
Union Representatives........						
Traveling Expense...........						
Telephone and Telegraph.....						
Printing and Stationary.......						
Hospital Expense............						
Lunchroom Expense..........						
Rearranging and Moving.....						
Salvage Dept. Expense.......						
Supply Variance............						
Retroactive P-R Adjustment...						
Outside Work Variance......						
Inventory Expense...........						
Warehouse Storage Expense..						
Royalties..................						
Dies for Customers..........						
Adjustment.................						
Engineering Expenses........						
Miscellaneous...............						
TOTAL BURDEN...........						
BURDEN LOSS............	——			–	–	–
DEPARTMENTAL EFFICIENCY	100.0%	%	%	–	–	–
DIRECT LABOR............	——			–	–	–
BURDEN RATE......... ..	%	%	%	–	–	–

(See Reverse Side for Detail)

ANALYSIS NON-PRODUCTIVE CLERICAL SALARIES	PERIOD	YEAR-TO-DATE
	Amount	Amount
Factory Clerical		
Cost and Estimating Dept.		
Planning Dept.		
Methods Dept. .		
Payroll Dept.... .		
Time Study Dept.		
Employment Dept.		
Purchasing Dept.		
Tabulating Dept..		
TOTAL		

ANALYSIS OF OVERTIME PREMIUM—FACTORY P/R.	PERIOD	YEAR-TO-DATE
	Amount	Amount
Total Per Series II...........		
Tool Room..................		
Maintenance Dept...........		
TOTAL		

Exhibit III

Company or Division ______________ Department ______________ No. ____

ANALYSIS OF DEPARTMENTAL BURDEN

PERIOD ENDED ______________

Foremen:

	AMOUNT			% to Direct Labor		
		ACTUAL		Desir-able	ACTUAL	
	Desirable	Period	Year To Date		Period	To Date
Supervision						
Indirect Labor						
Excess Labor						
Reoperation Labor						
Set-Up Labor						
Inspection Labor						
Material Handling						
Downtime						
Checkers and Time Clerks						
Supplies Used						
Spoilage & Waste						
Repairs & Maintenance: Machinery & Equipment						
Dies, Tools & Molds						
Plating, Polishing Fixtures						
Shop Trucks						
TOTAL						
Burden Loss	— —			—	—	—
Efficiency	100.0%	%	%	—	—	—
Direct Labor	— —			—	—	—
Overtime Hours	— —			—	—	—

Comments:

Exhibit IV

Company or Division ______________________ Department ______________ No.

ANALYSIS OF DEPARTMENTAL BURDEN

MONTH OF ______________________

	Amount		% Direct Labor	
	Month	Year To Date	Month	Year To Date
Supervision				
Factory Clerical				
Indirect Labor				
Excess Labor				
Reoperation Labor				
Set Up Labor				
Inspection Labor				
Material Handling				
Downtime				
Overtime				
Night Bonus				
Checkers and Time Clerks				
Supplies Used				
Spoilage and Waste				
Repairs & Maintenance:				
Machinery and Equipment				
Dies, Tools and Molds				
Plating, Polishing Fixtures				
Shop Trucks				
Power Consumed				
Gas Consumed				
Air Consumed				
Water Consumed				
Steam Consumed				
Depreciation				
Rent, Light and Heat				
Social Security Taxes				
Compensation Insurance				
Miscellaneous				
General Expense				
TOTAL BURDEN				
DIRECT LABOR			— —	— —

FOURTH SESSION

FRIDAY, MAY 20, 1949—7:00 P. M.

Deshler-Wallick Hotel

Chairman:

WALTER C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University*

Introduction of honored guests

Brief addresses were made by:

BRADFORD CADMUS, *Secretary, Institute of Internal Auditors, Inc.*

JOHN L. CAREY, *Executive Director, The American Institute of Accountants*

KELLEY G. SIDDALL, *President, Controllers Institute of America, Inc.*

ARTHUR B. GUNNARSON, *Secretary of National Association of Cost Accountants*

Address:

FRANCISCO DALUPAN, *President, The Philippine College of Commerce and Business Administration; President, Philippine Institute of Accountants, Manila, Philippine Islands*

Address: "Current Problems in Business and Accounting"

PERCIVAL F. BRUNDAGE, *President, The American Institute of Accountants; Partner, Price, Waterhouse & Company, New York, N. Y.*

ADDRESS

By Francisco Dalupan
President, The Philippine College of Commerce and Business Administration; President, Philippine Institute of Accountants, Manila, Philippine Islands

I have come all the way from Manila, Republic of the Philippines, at the invitation of the College of Commerce and Administration, through Professor Hermann C. Miller, to extend our greetings to the Ohio State University on the occasion of its Diamond Jubilee. In the first instance, I have come in representation of the Philippine College of Commerce and Business Administration of which I am its humble founding president. In addition I bring the felicitations of the Philippine Institute of Accountants of which I have the privilege to preside as President. I believe that I can also bespeak the adherence and support on this occasion of the generality of Filipino educators, and of that young Republic from whence I come—a new nation on the far side of the Pacific conceived by and in the image of American Democracy.

There are many reasons why we in the Philippines, and especially the educators among us, should share in the rejoicing that is the Ohio State University's on this occasion. Our educational system is historically an extension of the American educational system. Many of our active educators, not to mention our leaders in other fields of endeavor, are direct products of American universities, and our nation, such as it is today, is truly an implantation of the American way of life. We have often been called the "Americans of the Orient," and it has even been proposed that with the permission of that intrepid explorer, Admiral Richard Byrd, our country be called not Philippines, which is a name derived from and in honor of King Philip II of Spain, but "Little America."

I have said that our educational system is an extension of the American educational system. You know from your reading of history that when Admiral Dewey sank the Spanish fleet in Manila Bay and thereby tolled the death knell of Spanish rule in the Philippines, we had only a sketchy system of education. Only a small number of our children could get any schooling. The average Filipino youth was illiterate and only a handful of each generation, invariably the sons of the rich and well-born, could acquire college education. When the American forces landed in the Philippines, one of their very first acts was to open schools for Filipino children. American soldiers set aside their Krags and became school teachers wherever a town or a province was brought under American control. It is perhaps symbolic of the era dawning upon the Philippines that the first school opened by the Americans was located on Corregidor, the last Filamerican citadel to fall to the Japanese in the last War. As a former Governor General turned historian says, "The first public school opened by the American authorities was one on the Island of Corregidor, at the mouth of Manila Bay, within less than a month after the destruction of the Spanish fleet by Admiral Dewey. Less than three weeks after the occupation of the city of Manila the following August, seven schools were reopened and a teacher of English was installed in each under the supervision of the Reverend William McKinnon, Chaplain First California Volunteer Infantry."

What the American Army started the American Civil Administrators expanded and accelerated at such a pace that some 50 years later, when they handed over the reins of government to the Filipinos in an unprecedented act of international altruism and good will, a high percentage of literacy had been achieved, and every Filipino child of school age wishing to go to school was in school.

Determined to build up a once oppressed people into a democratic nation, the American Administrators strived not only to make every Filipino citizen literate, but also to give the people a common language. In the face of the use of many dialects by different sections of the country, none of which was sufficiently developed to be an adequate medium for a modern civilization, President McKinley, who incidentally was an Ohioan, having been born in Niles, Trumbull County, Ohio, January 29, 1843, decreed that that common language be English. Although the American Administrators of the Philippines brought other blessings such as economic development and the ballot, I feel that it will be the verdict of history that the most significant and most far-sighted American act in my country was the introduction of universal education through the medium of the English language.

That system of education and that language have been the primary instruments for the achievement of democracy by the Filipinos. The intelligent use of the ballot could not have been possible without universal education. The Philippines, separated into many islands and inhabited by groups speaking different languages, would never have been politically and spiritually united as a nation without a common language, one which is not only modern and capable of articulating and recording modern progress, but which is itself the very language of world democracy. Through English, the Filipino people, within the period of less than three generations, have become heirs to the immortal literature of democracy from the Magna Charta to the latest pronouncements of Churchill, Roosevelt, Truman and St. Laurent. It can perhaps be said that the entirety of America's generous bequest to the Filipino people is safely wrapped up with the English language.

More so perhaps than elsewhere in the world, the Philippine educational system has been the conditioning factor and yardstick of Philippine progress. It is estimated that approximately 90 per cent of the personnel of the government and of private business, including, naturally, almost all the top men, are products of the system. The President of our Republic, Elpidio Quirino, though born some ten years before America came to the Philippines, obtained all his education under that system.

But we have had the additional advantage of having had our educational facilities supplemented all along in a direct way by the American system of higher education. Many, if not most, of our citizens of light and leading have had the good fortune of acquiring additional training in American colleges and universities. These include most of our leading educators, journalists, professional and technical men. Perhaps the extent and significance of the training in American institutions of many Filipinos can be easily appreciated if I cite the fact that of the twelve members of our Cabinet, no less than five—the secretaries of the interior, justice, education, commerce and industry, and public welfare—are holders of degrees from American universities.

Parenthetically, I should mention that most unfortunately, since the granting of independence to us by virtue of an act of the American Congress, American colleges and universities have made it extremely hard for Filipinos to gain admission. We realize, of course, that as an aftermath of the war, there is or there has been a critical overcrowding in American schools. In America before the war, in any given school year, there were thousands of Filipino students, the number reaching its maximum in the years between the two world wars. Today, only some 100 Philippine government scholars, a handful of beneficiaries of the Fulbright Educational Act, enacted by the American Congress, and a few others lucky enough to secure admission through their own efforts, are found in the United States. Personally, I believe that American colleges and universities should make an effort to admit as many deserving Filipino students as possible. Although, as I have said, the Philippine educational system is patterned after that of America and is conducted on the basis of English, the polishing and finishing education that bright Filipino young men and women obtain in American schools will go a long way in continuing to link our two nations together culturally and spiritually.

To my way of thinking, America will continue to have an increasing stake in the success of Philippine democracy. By wresting the Philippines from Spain, training the Filipinos in self-government, and launching them as an independent nation, the United States has set up a new pattern in the treatment of subject peoples. Largely on the basis of her Philippine record, during and after World War II America enjoyed a moral ascendancy that was an indispensable prerequisite to her ownership of the mantle of world leadership. It is to America's interest that the Philippines shall not fail as a democracy. A continuing thoughtful American regard to our country, an important phase of which could be educational, will go far in assuring us the success necessary, of course, to our welfare, but also essential to America's unique position as world democracy's prop and protector.

The Philippine College of Commerce and Business Administration, of which, as I have said, I am the humble President, stands today truly built on a blueprint of the postwar American Educational System. It is an embodiment of the latest academic, administrative as well as architectural trends in American education adoptable in the Islands, a result of two surveys I personally made, first in 1946 and in 1947, of the different business schools in this country.

It started two years ago when a group of professionals including myself saw the need and demand for a progressive and up-to-date college after the four years of total war had flung the Philippines in darkness, and had left wasted its economic as well as its cultural life. We did not spare any effort to build up the present college. We have introduced the audio-visual method of instruction which has met with approval in all other schools, and I am proud to say that the system is fast being adopted by the other leading schools in our country. Modesty aside, I believe that we have made of the PCCBA, a replica of the modern and progressive American business schools.

Starting modestly with 351 students in April, 1947, and 1,241 in July, 1947, our enrollment jumped to over 5,000 in July, 1948. Encouraged by our progress, we opened the College of Dental Medicine in November of 1948, and plan to open, this coming school year, three other sister colleges, namely: a College of Pharmacy, a College of Education, and a College of Liberal Arts, preparatory to our becoming a full-fledged university in June of 1950. We have plans for academic and physical expansion and it is for this reason that I have come again, via Europe, all the way from the Philippines to the United States to visit the progressive schools I missed in my previous trips. In bringing to you greetings from a young institution, the PCCBA, I am here in addition, to learn, with your permission, whatever I can with a view of adopting my findings in our expanding college.

Speaking now for myself and those I represent, I am most grateful for the invitation to participate in this historic event. To the Ohio State University, I convey the felicitations of a grateful country on the occasion of her Diamond Jubilee. May she continue to hold her primacy among American state universities and thus make immortal the mandate to the Old Northwest Territory which she was among the first to implement, "Religion, morality, and knowledge being necessary to good government and the happiness of mankind, schools and the means of educational shall forever be encouraged." And may she have many more centuries of essential service and basic usefulness to this good state, to this great nation and to the rest of our unfortunately troubled world.

CHAIRMAN WEIDLER: Thank you, Mr. Dalupan. We are indeed happy to have you with us on this occasion, and we want you to know that we share your hopes and aspirations for the future of business education in your country.

Our next speaker has had a long and distinguished career in the accounting field. Immediately after his graduation from Harvard University in 1914 he started in public accounting with the firm of Patterson and Ridgeway. Two years later, in 1916, he resigned and joined the firm of Price, Waterhouse and Company, with which firm he has since been actively associated, except for a brief period during World War I when he served as Head of the Material Accounting Section—New York Depot Quartermaster. He was admitted to partnership in Price, Waterhouse and Company in 1930, and has served in both the New York and Boston offices. He is a Past President of Massachusetts State Society of Certified Public Accountants. He is now President of the American Institute of Accountants, and, over the years, he has served on numerous committees of the Institute; currently he is Chairman of the important Study Group on Business Income.

In addition to active participation in the organizations of his profession, he has maintained an active interest in national and international affairs. He is Past President of the League of Nations Association of New Jersey. He was Director of several relief organizations during the past war—The Unitarian Service Committee, The American Christian Committee for Refugees, and Refugee Relief Trustees.

It gives me great pleasure to present Mr. Percival F. Brundage who will speak to you on "Current Problems in Business and Accounting." Mr. Brundage.

CURRENT PROBLEMS IN BUSINESS AND ACCOUNTING

By PERCIVAL F. BRUNDAGE

President, The American Institute of Accountants; Partner, Price, Waterhouse and Company, New York

My subject tonight is within the general theme of this Institute. As Howard Greer said so humorously this morning, the problems presented by the decline in the value of the dollar have been frequently discussed during the past few months and the gloss has been worn off the subject. I am going to limit myself to a discussion of what I consider to be the three most important problems common to all business and accounting today. These are: 1. world peace; 2. freedom at home; 3. reduced taxation with lowered spending and greater government efficiency.

I

In my mind, the top problem today for all of us is how to obtain world peace with some kind of world stability. We must have at least a generation of peace in order to put our domestic house in order. The cataclysms caused by two world wars have upset our whole lives and the entire domestic economy, as well as causing untold agony. How to prevent their recurrence and to build a world order that will afford reasonable stability is our number one responsibility. My personal program is as follows:

1. Support the United Nations as an international cooperative effort of great educational and practical value as a sounding board of world opinion.

2. Continued firmness in preventing the spread of communism and dictatorships. We have proved again, if it needed proof, that appeasement does not pay. Rearmament, the success of the Berlin airlift, the formation of Western Germany are all constructive steps in this program.

3. Encourage European reconstruction under the Marshall Plan and E.C.A. We have come to realize that we cannot have a stable U. S. economy in the midst of a world vacuum. We are even helping to build up our international competitors, in order to restore sound business conditions in Europe. This is practical business sense.

4. The Rio de Janeiro Pact should be implemented. This pact between nations in the Western Hemisphere converted the Monroe Doctrine from a unilateral pronouncement on our part to a multilateral agreement. This has removed the undercurrent of fear throughout many of the Latin American countries of so-called "Yankee Imperialism."

5. The Atlantic Defense Pact should be approved and the more expeditiously

it is done the better. This is a necessary further step in the strengthening of the western European democracies. Every one of us should urge its approval by Congress.

6. We should go a step further, in my opinion. Military preparedness by itself is negative and so is stopping communism. We need to take a positive and dramatic step forward in order to demonstrate our firm belief in democracy, and in our own tried system of government. We should propose to those peoples who have practiced democracy in their own governments, and who allow civil liberties to all of their citizens to join with us in a common federal government. We should convert the Atlantic Pact into an Atlantic Federal Union.

The Atlantic Ocean today is no longer a barrier but a highway, a bond between the nations bordering upon it. It can be crossed by air in 10 hours, and it is safer to fly over than land masses like the Appalachians and the Rocky Mountains. It can be crossed by fast boats in 5 days, and is the cheapest means of freight transportation. The Greek and Roman worlds centered around the Mediterranean, but the Mediterranean in the days of galleys and sailing ships was less convenient, relatively, than the North Atlantic today. The closest financial and business ties already bind the Atlantic democracies together—70 per cent of their business is done with each other.

The machinery of government differs among the democracies in detail, but in all of them it is based on the individual as an equal unit. It follows the same broad lines of representative government, and aims to secure the same minimum guarantees of freedom to the individual.

If a Federal Union of the Atlantic Democracies were to be adopted and a House of Representatives were to be formed, with representation proportionate to the population, and this proportion were set at one representative of 1,000,000 people, the American people would elect 143 representatives; Canada, 12; the United Kingdom, 47; France, 41; Belgium, 8; Holland, 9; Luxembourg, 1; or a total of 261. Of this total, the U. S. representatives would, of course, have a clear majority.

The nations within such an Atlantic Union would have a common foreign policy, common armed forces, a common currency, and would be empowered to regulate commerce between the states composing it. Our own domestic institutions would otherwise operate as at present.

This Federal Union would be definitely within the framework of the United Nations and no amendment of that charter would be necessary, but it would be outside of the Russian veto. Decisions within such a commonwealth would be reached by majority vote. The door would be kept open and other freedom-loving nations which recognize the dignity of the individual would be invited to join at a later date. We would be pursuing just another step further the same principles that were adopted when we formed the Federal Union of our thirteen colonies, 160 years ago.

I realize that it will require education and great leadership to achieve such a Union, but that is true of all progress. I have reread the Federalist papers recently, and also a life of Alexander Hamilton which bring out how much effort on the part of a few leaders was necessary to convert the early loose confederacy of the thirteen states into a Federal Union. What a difference it would have made in our own history if this had not been accomplished? As a public accountant trained in matching costs against benefits, I think that an Atlantic Federal Union would accomplish what we are striving for at considerably less cost than doing it separately.

Last week the United States Council of the International Chamber of Commerce issued a significant report pointing out the immediate necessity for reductions of tariffs, elimination of preferences, of quantitative restrictions, and of exchange controls among western European democracies. This report also called for the free convertibility of currencies, encouragement of tourism, restoration of competition, and provision of incentives for private traders. This is exactly what an Atlantic Federal Union or a United States of Europe would provide. Without them the E. R. P. program will not have lasting effect.

One suggested alternative is a United States of Europe, but an Atlantic Union has the advantage that we would be lending our tremendous resources and backing to member states of the Atlantic Union rather than to what would be a foreign country, which would be more effective and less costly. It would also give additional protection to our North Atlantic Continent in case war should come again within a generation.

The real lesson of the Revolutionary War was not the separation of the American colonies from Great Britain, but rather the Federal Union of the 13 states that came after the first confederation proved ineffective. This subject I consider so important and of such immediate concern to all of us that I urge it upon your attention.

II

My second point involves the question of balance in our domestic economy between freedom and regulation, between initiative for the individual and control by the state. The advantages of freedom are generally recognized but there are a number of factors in this country working for more regulation and closer controls of business and accounting.

1. We have reached the end of a pioneer age and are approaching a stabilized economy. In the frontier days, individual initiative was essential

for survival and was encouraged by government policy. That is no longer true. We seem to have lost the craving for excitement and the willingness to take risks. The demand for protection from our government is greater than for new opportunities. Our recent leaders have stressed four freedoms —freedom of speech, freedom of worship, freedom from want and freedom from fear. The first two are the freedoms for which our forefathers left Europe and came to this country. The last two are an expression of more recent tendencies, which, to my regret, are being substituted in importance for the earlier freedoms. There is indeed an important difference between these two types of freedoms. Our forefathers emphasized the freedom of an individual to express himself and to develop initiative. We now find an emphasis on security and protection. We ask our government to prevent the evils which formerly each individual fitted himself to fight against.

2. We have a much wider and more effective educational system than 150 years ago, or even 50 years ago. This system emphasizes the common rights and privileges of all, but I regret to say, does not adequately stress the common obligations and responsibilities of citizenship. I am referring to our primary and secondary schools and not our state universities. These schools teach about the remarkable developments in science. The major emphasis seems to be placed on such things as the intricacies of electronics, more and more complicated engines and machines, new gadgets to lighten household tasks and make living more enjoyable. Our educational system does not emphasize enough the need for better understanding in our social relations, and the responsibilities that come with maturity in the life of a nation as well as in the life of an individual.

3. Our concepts of government and business life have developed under a strong legalistic background. We are continually searching for a legal precedent or an apt citation to support a decision instead of something new and original. Our daily lives are regulated by laws. Whenever we find something wrong that stirs the imagination we rush to pass more laws or make new regulations to provide what each one can do or cannot do. We are unwilling to trust the sound judgment of the majority of our citizens to decide for themselves what is best for the community.

In every civilized society there have to be some laws and some control so that one man's freedom will not be used to take away another man's freedom. But the extent of control by public authority tends to grow in geometric progression. Furthermore, these controls are being exercised by so many different authorities that there are constant conflicts. The Department of Agriculture, for instance, is working at the same time for increased production and for higher prices for farm products. The Department of

Labor is advocating both higher wages and a lower cost of living. All kinds of arguments are advanced and various devices proposed to accomplish these conflicting aims. We all agree, I suppose, that free competition should be encouraged and monopoly regulated. The real problem is how to balance the one against the other. We need to have more faith in the democratic process. We have found it at times to be awkward, ineffective and slow to recognize and correct what our more impatient liberals feel to be crying social and economic evils. But it is better than anything else that has been discovered. We must continue to experiment and evolve a way of reconciling our individual freedoms with a moderate measure of control and regulation. Our future will depend to an important extent on how effectively this can be accomplished.

III

Third among the joint problems of business and accounting to which I wish to call your attention is taxation and the closely related subject of government efficiency. The burdens of local, state and federal taxation are heavy indeed. They take 25 per cent of our national income. Unemployment relief, old age pensions, veterans benefits, free medical care are admirable in themselves, but they are not self-supporting and some one has to pay for them. The cost of our public services today very nearly absorbs all that part of the national income which used to be saved, which made possible our tremendous productive capacity.

There are a number of things in our present tax statutes and administration which should be improved. Many of these will be discussed tomorrow morning. The American Institute of Accountants has advocated a number of changes.

It is my particular concern that more liberal deductions be allowed for depreciation, either on the basis of the present value of the dollar or accelerated depreciation during the early years of the life of newly-acquired equipment. The recent action in Great Britain by the Chancellor of the Exchequer, Sir Stafford Cripps, is to me most significant. He has increased the initial allowance in respect of plant and machinery purchased on or after April 6, 1949, to 40 per cent of the new cost, plus normal depreciation for the first year.

But however important this and other relief provisions may be, I have a strong feeling that we should have a moratorium on tax legislation this year. The President's recommendations to Congress, and the various welfare projects under consideration indicate that any tax relief provisions which may be proposed would be snowed under by demands for more taxes to take care of increased expenditures. If a new bill is introduced I am very fearful that we would end up with a worse act rather than an improvement on the present Revenue Act.

We should plan for the future, however, and urge the appointment of an advisory tax commission of experts such as the Magill Committee, which should be made a permanent organization for the study of tax problems and the development of a sound tax policy. Such a commission should be independent of the Treasury, should be non-partisan and include C.P.A.'s, lawyers, economists, and representatives of capital and labor. This expert body should consider the social and economic effects of various types of taxes—income, excise, sales, luxury, etc., which of these taxes should most appropriately be used for federal revenue, and how high the rates can be set without danger to our economy. It should also consider the possibility of simplified multiple-purpose tax returns. These returns, when prepared and signed by a C.P.A., would be subject to review by the Treasury, but not to audit in the field, except in cases of suspected fraud. Such a commission of experts would realize how important it is to have the fewest possible changes made in the tax structure from year to year. Business must budget ahead, and proposed changes, or even the fear of changes, seriously disturbs business planning. Such a commission should be asked to make a study and report to Congress, say in 1951.

In addition, I think that we should all work for a Tax Settlement Board along the lines of the Mills Bill, HR 2983, recently introduced in the House. So long as tax rates remain high, it is important that taxpayers feel that they are getting a square deal without undue expense. Last week I spent a morning in the Bureau of Internal Revenue with the Assistant Commissioners Martin and Bolich and some of their top staff. They felt that the conferees in the Bureau and the technical staff were trying to give taxpayers a fair break in settlements. The representatives of the Institute, however, pointed out that these settlements were made by a branch of the Bureau which collected the tax, and that taxpayers frequently agreed to settlements in order to avoid the cost of litigation, but with some feeling of resentment which was found to have unfortunate effects on our economy as a whole. Furthermore, the Treasury Department and the House Ways and Means Committee originally proposed that the Board of Tax Appeals, now the Tax Court, constitute just such an informal Settlement Board. Mr. Gregg, the Solicitor of Internal Revenue, at the time testified as follows:

> The Treasury Department originally recommended a board in the Treasury Department with informal procedure to settle tax cases. It was recognized at the

time that there were two needs, one for a board to settle tax cases, and I mean settle them in the case of settling them across the table, and the other a court to establish precedents, the latter (not?) for its value in deciding the cases which would be presented to it, because they necessarily must be limited in number, but for the purpose of establishing precedents to guide the Bureau in the settlement of other cases and to guide the taxpayer in disposing of his case . . .

The original recommendation of the Treasury Department was for a board to settle tax cases. Congress changed that and gave us the other, which was also much needed: a court to establish precedents for the disposition of other cases pending in the Department.

Wide public support for the Tax Settlement Board has developed throughout the country. Coincident with the study and enactment of sound tax legislation we must immediately tackle the problem of greater government efficiency. The government of our cities, states and federal system should be a model of economy and efficiency, and not a butt of ridicule. Fortunately, we have at hand a thorough-going study and series of reports that give us just the opportunity that we need.

Our federal administrative machinery was built up during the war to colossal proportions, and there is much that is unnecessary and inefficient, as well as much that needs to be retained. The Hoover Commission on the Organization of the Executive Branch of the Government was created by an act of Congress, approved July 7, 1947. It was an instrument of the Congress, not of the Executive Branch. Its duties were to make an investigation and then to report findings and recommendations to the eighty-first Congress.

The law which created the Commission contains a declaration of policy which reads as follows:

> Section I. It is hereby declared to be the policy of Congress to promote economy, efficiency, and improved service in the transaction of the public business in the departments, bureaus, agencies, boards, commissions, offices, independent establishments, and instrumentalities of the executive branch of the Government by:
>
> (1) limiting expenditures to the lowest amount consistent with the efficient performance of essential services, activities, and functions;
>
> (2) eliminating duplication and overlapping of services, activities, and functions;
>
> (3) consolidating services, activities and functions of a similar nature;
>
> (4) abolishing services, activities, and functions not necessary to the efficient conduct of government; and
>
> (5) defining and limiting executive functions, services, and activities.

This was certainly an admirable objective and outline of duties. The

Commission decided not to undertake its work primarily as a direct staff project, but to subdivide it into units, and to employ the services of outstanding people from various walks of life whose experience, background and other attainments made them peculiarly well qualified for the responsibility. There are separate projects on the Government's lending agencies; the Post Office Department; the President's Office; the problems generally described as fiscal, budgetary and accounting; the regulatory agencies, such as the SEC, the ICC and the Federal Reserve System; the whole broad field of personnel management; the field of agriculture; the field of natural resources; and others.

Each group of people which undertook a project was called a task force. In some instances, the task forces were under contract; in others, there were informal committees, and in some cases, single individuals. In all, more than three hundred people took part in the studies, either as task-force members, or as members of advisory committees assisting them.

Each of the task forces was given full responsibility for its assignment, and the Commission was exceedingly careful not to interfere with the autonomy of the groups. The task forces were required to report to the Commission, and the Commission undertook to study the various reports and to prepare its own reports on the basis of the work of all of the groups. The job of integration and the job of "selling" the recommendations were tremendous undertakings, and the time available was very short. It was a monumental project.

In reporting to the Congress, the Commission issued thirty-seven separate printed pamphlets, each of which has become a public document, available for general distribution. Eighteen of the pamphlets are reports made by the Commission itself, and the other nineteen are task-force reports, addressed to the Commission. While these thirty-seven documents do not form an integrated blueprint of Government organization and could not be expected to do so with such a variety of participants, the analyses and recommendations cover every field of the Executive Branch.

The individual Commissioners hold divergent views on many of the subjects with which they dealt, and their reports contain many dissenting statements and explanations. This is particularly true in the field of government business enterprises, the last of the studies to be reported, and perhaps the most controversial. Many of the task-force reports contain proposals which were not adopted by the Commission's majority, or by its minorities, and these, too, contain interesting statements by responsible and well-informed citizens.

The reports themselves are somewhat complicated and need to be summarized by some accountant familiar with the present government organization. When I first read them I felt somewhat like the little girl that Mr. Hoover told about. This little girl had expressed an interest in penguins to an elderly friend who thereupon sent her a book on the subject. At a much later date she duly acknowledged the gift. "Thank you for the book about penguins," she said. "It tells more about penguins than I really want to know."

I felt that some of the technical points might have been omitted and then I was ashamed of myself, because that is why the government is not run efficiently. Too many of us are absorbed in other things and do not take the trouble to find out about it.

It is exceedingly important that each of you obtain copies of these reports and study them. The recommendations are so far reaching and controversial that there is grave danger that nothing will be done about them unless strong public pressure is brought to bear. We will not have another opportunity like the present to accomplish a major change in governmental organization, both to improve the efficiency and reduce the cost of our federal government.

Fortune Magazine in its May issue has a special supplement entitled "Big-Government—Can it be Managed Efficiently." I commend this article to all of you.

The May 14 issue of the *Saturday Evening Post* also contains an interesting article by Leslie A. Miller, ex-Governor of Wyoming and Chairman of the Natural Resources Committee of the Hoover Commission, which would interest all of you. You should read about the Cherry Creek project, and other specific instances which he cites, where hundreds of millions of dollars have been wasted. He shows how easy it is to spend billions of the taxpayers' money without an essential need, or, without commensurate results. He makes the following specific charges against the army engineers and the Bureau of Reclamation. He says:

> These two agencies are so violently jealous of each other that an extravagant and wholly senseless competition has sprung up. They will encroach on each other's territory and stake out rival claims simply to beat out each other in the race to construct expensive projects. Naturally, it is the taxpayer who suffers . . . In their indecent zeal to extend their empires, both agencies are guilty of underestimating—apparently deliberately—the cost of the projects they proposed.

An analysis of what all the federal agencies—Engineers, Reclamation, Department of Agriculture and Federal Power Commission—have spent and were planning to spend on water resources development is as follows:

1.	Works already completed	$ 4,779,700,000
2.	Projects under construction	4,593,000,000
3.	Projects definitely planned	18,980,900,000
4.	Projects planned for the long-range future	29,152,600,000
	Total	$57,506,200,000

One very unfortunate part of this natural resources picture is that Senator John McClellan of Arkansas, a member of the Hoover Commission, is also President of the National Rivers and Harbors Congress which is strenuously fighting the recommendations of the Commission, many of which vitally affect itself. It is Senator McClellan, also, who has hindered the chances of putting any of the Hoover recommendations into effect by amending the bill before Congress, granting the President power to reorganize the Executive Branch of specifically providing that anything the President does to make the Executive Branch more efficient may be disproved by either the Senate or the House within 60 days.

It is natural that there is violent opposition to most of the more important recommendations by those whose opinions were ignored, whose departments are to be eliminated, or whose functions are to be curtailed. This is human nature. There is also general opposition to giving President Truman wide powers in any field. Unfortunately, the only way to get the Hoover recommendations adopted is to give the President general powers to reorganize the Executive Branch.

It is desirable for all of us to write our Congressmen and Senators, prepare articles for newspapers and magazines, and give the recommendations all of the publicity and encouragement that they deserve. T. Coleman Andrews, Vice President of the Institute, is a member of a newly formed citizens' group which is pressing for action on the Hoover recommendations. Either he or I would be happy to know of any of you that have the time and are willing to work for this project. This is called the "Citizens Committee for Reorganization of the Executive Branch of the Government," and Dr. Robert Johnson is the chairman. Dr. Johnson, in Boston a few days ago, summarized the facts found by the Hoover Commission very briefly as follows:

> In operation, the Executive Branch ignores the simplest principles of good management. Any private business or household would go broke overnight if run on government lines. There is lack of executive authority and responsibility everywhere. Thousands of people are hired by personnel people they have never seen, to work under frustrating conditions for people *they* have never seen. All this takes place in a haze of pointless, red-tape paperwork. Budgeting is a series of mathematical mysteries which usually tell what *things* the money will buy

but rarely what purpose they will serve. Accounting sometimes lags years behind expenditures and is neither assembled in terms of complete costs nor reveals results in terms of performance.

He also summarized the essence of the recommendations as follows:

> The Report recommends just what you would expect—the application of the simple principles of good management. But these are spelled out in detail, department by department, and function by function. Suffice it to say that the Commission's recommendations, taken together, make a glorious amount of simple common sense. . . .
>
> As to potential savings, the Commission itself refrained from making an estimate, so great are the variables when projected very far into the future. Mr. Hoover has personally expressed belief that at least $3 billions a year could be saved without damage to essential services. This is based on some of the estimates of the task forces and I feel sure that it errs on the conservative side. An estimate of $4 billions might be closer to the truth, if reorganization is vigorously prosecuted.

I have only one more point to make. In addition to reducing taxes, or at least preventing their increase, and improving efficiency of Government, we must prevent an increase in spending that would increase the national debt. The President's budget submitted in January last contains some 40 spending proposals which require new legislation by Congress. This is exclusive of major military and foreign commitments. Many of the President's proposals open up new fields of spending. As Mark Sullivan said in a recent article:

> Dedication to economy can come only from Congress, and only if dedication by Congress has the support of dedication by the people. The test of any proposal for new spending is not absolute, it is not whether the purpose of the new spending is desirable. The test is comparative, whether the new spending is more desirable than arresting an increase in the national debt.

You may ask why I have been so general in my remarks, and what this has to do with accountants. During the past few months, as President of the Institute, I have visited a number of states and talked with a number of leading accountants who are also business leaders in their communities. I believe that our profession should train us to understand and interpret ideas as well as facts and figures. I envisage, within a very short time, an important increase in the community's appraisal of the importance of the accounting profession. I hope that many of you here will serve in State Legislatures, in Congress, and in important public posts. The problems I have set forth are, I believe, the most important problems of the accounting profession, as well as of business.

FIFTH SESSION

SATURDAY, MAY 21, 1949—10:00 A. M.
Deshler-Wallick Hotel

Chairman:

ROBERT L. DIXON, *President, American Accounting Association; University of Michigan, Ann Arbor, Michigan*

Address: "Effect of Changing Business Conditions on Tax Policies"

KELLY Y. SIDDALL, *President, Controllers Institute of America; Comptroller, Proctor & Gamble Company, Cincinnati, Ohio*

Address: "Current Tax Developments"

EDWARD N. POLISHER, *Attorney, Philadelphia, Pennsylvania*

INTRODUCTORY REMARKS

CHAIRMAN ROBERT L. DIXON: Welcome to this, the final session of the Ohio State University's Institute on Accounting. It is my conviction that people do not pay too much attention to the Chairman of the session so I shall confine my remarks primarily to introducing your speakers.

Our first speaker is at present the President of the Controllers Institute of America, a very, very fine organization and a very distinguished position to hold. His more remunerative job is Comptroller of Proctor and Gamble Company of Cincinnati, Ohio. He has been prominently active in the Controllers Institute for more than a decade before becoming its President, having served as a National Vice-President, 1944-1946; National Director, 1944-1947; Chairman of the National Budget and Finance Committee, 1946-1947; and as General Chairman of Industry Conferences at the Institute's 1944 Annual Meeting.

He has at various times served as Treasurer, Secretary, Vice-President and President of the Cincinnati Control. He is a graduate of the University of Cincinnati and has been associated with the Proctor and Gamble Company since 1926 where he became manager of the Cost Department in 1931, Chief Accountant in 1939, and in 1942 was made Comptroller of the company and member of the Administrative Committee.

He is also active in community affairs, being a member of the Board of Directors of the Cincinnati Red Cross, Budget Consultant for the local Community Chest, and a member of the Chamber of Commerce. He also serves on the Suburban Branch Board of Management of the Y.M.C.A.

A final distinction which I believe is no mean qualification, is the fact that he has been invited to appear on this program. I am pleased to present Mr. Kelly Y. Siddall who will speak on the subject "The Effect of Changing Business Conditions on Tax Policies." Mr. Siddall.

EFFECT OF CHANGING BUSINESS CONDITIONS ON TAX POLICIES

By Kelly Y. Siddall

President, Controllers Institute of America; Comptroller, Proctor and Gamble Company, Cincinnati, Ohio

Since 1913 the U. S. Fiscal Policy and the Federal Tax Policy which supports it has become the concern of every U. S. business man. Therefore, from the business man's viewpoint the question I should like to discuss today is, "Are changing business conditions reflected in changes in tax policies?"

Originally, taxes were considered simply as the source of revenue needed to support federal, state and local government. During the past fifteen years, we have seen that original concept continued, but with the additional concept of taxes as a tool for social reform. There have been "taxes to shift the wealth," "taxes to care for us from the womb to the tomb," and "taxes to curb inflation." Right now, in addition to all of the others, we are paying taxes "to support the world." This latter is the old original support idea expanded to world-wide proportions.

The trend has been towards turning the tax policy into a political instrument. The brain-trusters of the 30's told business that depression pump priming and the resulting deficit financing was temporary, but necessary. They said then that government expenditures must be way beyond tax receipts, because heavy taxation during a depression produced an increased burden on corporations and individuals already hard put to keep their heads above water. They assured us that when the pump was primed the resulting prosperity could easily carry a tax program which would wipe out the deficit. Whether that plan could have succeeded is an academic question today as the result of World War II.

We all know that tax laws are not changed easily and we can point to two simple examples. We clamored for years before getting the income-tax-splitting bill in 1948, but in spite of the fact that practically every well known authority and all associations interested in taxation have long been howling for the elimination of the double tax on dividends, we still have it with us. Sometimes, the government even gets stubborn about passing laws to give them more taxes. Life insurance companies have not paid income taxes in two years, and in spite of strong urging from Treasury Secretary Snyder, the government has, rightly or wrongly, done nothing about it.

Perhaps, however, this slowness in the response of the tax laws is not altogether bad. We must remember that regardless of how changing business conditions affect tax policies, it is certain that changing tax policies *do* cause some local or national changes in business conditions. Few businesses like to change their policies to meet a changed tax situation, or even to plan such policy changes for tax reasons. Business leaders, like good generals, must have plans ready for a retreat as well as an advance. They must be prepared for tax as well as business contingencies.

I want to recall one example which, to my way of thinking, illustrates the thought that changing business conditions do not always call for a changed tax policy. It is appropos of the fact that we must pay attention to the long-term effect of tax policies rather than the short-term effect. My example deals with the question of tax recognition of depreciation on replacement cost basis. Will the man who is asking for depreciation on a replacement cost of $2,000 for his equipment costing $1,000 when installed in 1939 like the replacement basis of depreciation later when the replacement cost on that same equipment is $500? Where were the proponents of this system in the early 30's when replacement costs generally were way below original cost? I do not believe that we should be naive enough to think that we are always going to have these high costs, or that the Internal Revenue Bureau would allow us depreciation on replacement cost when it is higher than original, and allow us to use original cost when original cost is higher than replacement.

As you can tell from these remarks, I am not in favor of depreciation on replacement basis. It is interesting to note that while the U. S. government has done nothing but listen to the talk about it, the English government, in its new budget program, has increased the first year depreciation allowance from 20 per cent to 40 per cent. If something is finally done about it over here, I hope that we can use the same method of solving the problem.

A tax policy that is against the operations of natural business conditions has about the same chance of success as the prohibition law. For example, let us take family partnerships. The Internal Revenue Bureau has been very busy for years fighting family partnerships, a natural part of our business economy. The 1948 split-income provisions, undoubtedly, will help to eliminate a lot of grief on that score.

As a second example, let us consider the case of a corporation wishing to sell its business to another corporation. Businesses are being sold all the time, but we do not have a good clean way of handling such a transaction. The most clear-cut and natural way of handling involves double taxation, so we still have to go around through the back gate to avoid double taxation. A great many prospective purchasers of corporations prefer to buy assets rather than capital stock. This is understandable, as it avoids possible trouble with the Clayton Act, and possible liability from undisclosed claims against the acquired company, or law violations by it. On the other hand, most corporations and their stockholders can not afford to quit business through the sale of assets. It was not until the Howell Case in 1947, and the Cummins Distillery and Baum Cases in 1948, that even the path to the back gate was clearly defined. While the road to avoid double taxation is now known, it is not one that can easily be taken by many of the companies wishing to sell. It is certainly not to our government's credit that corporations who do sell are forced to do business in an unnatural way to avoid unjust taxation.

As a third example, let us look at the operation of section 102. I am sure that none of us will argue against a penalty for improper accumulation, but has this section been used exclusively for the purpose originally intended? I think not. Most liable to get in trouble due to section 102 is the small business man, who, as we all know, is the very man the administration has for 16 years been trying to help. Small businesses, generally, are closely held, and their growth must come from retained earnings. Yet, the whim of a revenue agent can create untold trouble for the fellow who can stand it least.

Then, there is the age-old fight between equity and debt financing. I refer particularly to the preferred stock type of equity and its disadvantage taxwise when compared to interest bearing debt. Should we continue to penalize equity financing? While our economic system is certainly built both on equity and debt financing, shouldn't we encourage the type of equity investment which most closely resembles debt financing by making preferred dividends deductible for tax purposes?

These are all cases where the natural operations of business are hampered by tax policy. Changes are sorely needed, and I feel confident that changes will eventually be made.

Over the years, our tax laws have become more and more complex and with such a change has come a widening of the area of judgment left to the tax administrators. These administrators are being given, and are assuming, an increasing control over the changes in the technical as well as the administrative provisions of the code. The "critical situations" demanding immediate actions, so familiar to us in other branches of the government, have also become a tool of the taxing agencies. They have found that Congressional intent can be modified through regulations and court decisions. Rather than face the more difficult task of getting legislative approval for changes desired by them, the administrators frequently cultivate litigation favorable to their cause by the simple expedient of carefully selecting the cases to be tried. This procedure has certainly not made it easier for the business man to live within the total tax structure.

The Treasury's continuing attacks on charitable foundations engaging in business is a good example of how the revenue bureau keeps on attempting to make its view the law of the land by litigation. While court decisions do not uphold the Treasury's position it is still necessary for many of the foundations to go to court to retain their exemptions. The controversy revolves around the question as to whether it is the source of revenue or the use to which it is put, that determines the exemption. The Treasury Department holds that it is the source, whereas the courts have given broad exemptions based on the use theory. The matter is now before the tax court on the New York University Case, and may go on to the Supreme Court. If the Treasury Department is as anxious to protect private business from tax-free foundation business as it purports to be, then why does it not take the same attitude in connection with co-operative business concerns?

While we are pointing out many ways that business conditions have not yet changed the tax policy, let's be honest and admit that the "taxation weather" has not all been bad. The introduction of form 1138 in 1945 was a move in the right direction, even if it took several years for us to get something that should have been in the original law. This allowance of time for payment of taxes by corporations expecting carry-backs was important when such was made possible. It must be of terrific importance today, and in the future, to the large number of smaller firms where working capital is not so easily obtainable. Such moves as this to alleviate the already too numerous complications of carrying on a business, offer some recognition of a business man's woes.

While the idea of adopting some quick and easy method of settling tax claims is not new, the tight money situation which American business has experienced in the last two years is, undoubtedly, the basic reason for the introduction of the Mills Bill (H.R. 2983). Mr. Brundage, who addressed us last night, has called the proposed creation of the Tax Settlement Board one of the most constructive suggestions in the history of tax legislation. The Board will permit quick and inexpensive settlement of the majority of tax cases; it will relieve the tax court; it will also mean that many millions of dollars sorely needed in business will not be paid out unnecessarily, and then frozen in long-drawn-out legal tax tangles. It will help the little fellow to get a better determination of his tax obligation.

The Treasury Department takes the opposite view and maintains that the proposed twenty-five man board would make settlements slower, that the Board could not handle the mass of tax disputes, and—believe it or not—it has been reported in the public press that treasury men object, also, on the basis that it would encourage taxpayers to contest small deficiency assessments that they might otherwise pay. Incidentally, I think we should also report that while the accountants are backing the board idea, the lawyers, for reasons too obvious to need mention here, are not favorable toward the idea.

The Reed Bill (H.R. 3113) would transfer the tax court to the Federal Judiciary, making it a court of record. The final effect of the enactment of such a measure cannot be forecast at this time, but, apparently, it has few supporters and one very important opponent—The American Institute of Accountants.

One of the latest helpful ideas to come from the Treasury Department is in connection with U. S. taxes on earnings abroad. With the many restrictions placed on currency exchange, it has been very difficult in some countries, and practically impossible in other countries, to transfer profits to the United States. This has not, up to now, kept the U. S. revenue people from demanding their share of something the U. S. business man had on paper but not in his pocket. The proposed regulations, if approved, would allow us to defer reporting, for tax purposes, profits which were prevented, by foreign government rules, from being converted into U. S. dollars. This play may not be approved, but it does show evidence of cooperation with business, and it would not cost the U. S. government any money in the long run.

I believe we should give credit to some of those in the tax policy making picture for possessing a real desire to straighten out the situation. Mr. Colin Stam has shown that he is really interested in what business feels is wrong with the tax laws. In addition, we must not forget the late lamented H.R. 6712 of the 80th Congress. About half of the changes in that bill were directly for the benefit of business, and that bill went into the House with the committee's blessing worded as follows:

> The bill will remove inequities, eliminate uncertainties for both taxpayers and tax administrators, prevent tax avoidence, simplify the tax system, moderate certain harsh provisions and provide increased incentives to management and venture capital.

I am sure you will all agree that if we could see a tax revision bill which did all those things become the law of the land, we would be seeing the ultimate result of business conditions molding the tax policy.

Unfortunately, that bill did not become public law, and so we are still faced with many problems of coordinating business and taxes. A great deal of argument is going on around about us over the size of the tax rates. We find both those in favor of making individuals carry most of the load and those who think that business taxes should provide the main source of revenue. When it comes, however, to the other items—let's call it the "fringe" element—we find almost 100 per cent agreement that certain current code provisions should be changed or eliminated. This fringe element badly needing attention includes:

1. The 2 per cent sonsolidated return tax.
2. The inter-corporate dividend tax.
3. The short carry-forward time.
4. Stock options.
5. Application of Section 102 tax to total income.
6. The high interest rate on deficiencies.
7. Lack of full current recognition of capital losses, etc.

There is such unanimity of opinion that we find ourselves asking the question—why isn't something done about it? This is one of those cases where there is more to it than meets the eye, so I will let you concoct your own answer to the question.

Another matter causing business men concern is the present rivalry for the tax dollar between the Federal, State, and local governments. If we have a lowering of business activity with a resulting drop in the tax take, this rivalry will be increased. You will remember that the Hoover Commission expressed the hope that the federal and state tax programs could be untangled, and a meeting was held recently to pave the way for better cooperation. The question of who gives up what to whom will not be easily settled, and I believe that the final result will not be a savings in taxes. The effort could be very worthwhile, however, if it only helps to eliminate some of the over-lapping and red tape.

The U. S. government and corporate business are not the only types of entities that are reeling under the load of high wages and high costs of all kinds. The state and local governments are faced with the same problems and we have seen an evolution in the tax policies they follow. The increase in educational costs, for example, has many a local government with its back to the wall. Not only have costs increased, but schools are occupying more and more tax-free property which, of course, reduces the tax take. In the past, most local governments have not had too much difficulty in raising taxes for educational purposes, but, unfortunately, the tide seems to have turned the other way and that bodes evil for our American school system.

As there has been a change in the course of federal revenue so also has there been a change in the local revenue source. The old local tax policy of property taxes was enlarged to take in sales, admissions, and other excise taxes some time ago. Several states have had income tax laws for quite some time, but only recently we have seen a new pattern of local finance developing to include city income taxes. Long thought unsuitable for use at such a level, the city income tax has, nevertheless, been rather rapidly springing into use since Philadelphia first adopted it in 1940. The real growth, however, has been since the war. Today, we can point to a large number of cities, including several in Ohio, which have income taxes, usually taking the form of pay roll deductions of 1 per cent or less. In one state which borders on our own, even school districts and townships have followed suit.

As an example of local-level tax thinking, let me cite the New York City "container" case. While it is local now, the outcome could affect many cities and states having sales and use taxes. Like most taxes of this nature, the New York City tax applies to goods sold and delivered to ultimate consumers within the city, or to goods brought in from elsewhere for use within the city. The city's first effort to tax the value of the shipping container individually was directed at the manufacturers who packed their products in such. However, the courts did not uphold the city's position. The current effort is directed at retailers, on the theory that because the container is not delivered to the housewife the retailer has consumed it. Obviously, of course, the tax on the container has been paid by the housewife when she pays for the product she takes home, since the retail price must include the container cost. I cite this just as another example of what can happen to business when a taxing agency begins to dig deep for money.

Let us return in our thinking to the national scene and see what is happening in Washington right now. Today's financial burden and the business outlook for the future has caused business to stop, look and listen, and, fortunately, Congress is doing the same. We are soon going to see whether the new concept of taxes as an instrument of government policy means that the problems of business have little or no effect on taxation policies.

The very fact that Congress is re-examining the tax program in the light of today's uncertain business conditions is in itself a partial answer to our question. The Congressional committees concerned with taxes are hesitating before burdening business with the administration's request for additional taxes. Congress is afraid that increased taxes, coupled with the expected decline of business, would break the economic back of our nation. I might add, parenthetically, that while Congress is showing this evidence of trying to find out what is going to happen to business before the tax policy is established, they have shown little evidence of realizing that government expenditures should be adjusted to the tax policy. If they continue to appropriate billions, as they are now doing, it may be too late to consider business conditions when writing the new tax law.

For the first time in several months, the President's Economic Council seems to be in substantial agreement as to the current status of our economy. Instead of calling for inflationary controls, the April report openly admits that prices are continuing downward and we understand that the council's advice to the president probably was to ease off in his tax requests, and, if possible, to trim federal spending. It looks like the advisors have finally caught up with the facts of life. While it is reported that the council advised some curtailment of excise taxes and a delay in the increase in social security taxes, which, of course, would be very beneficial to business, the main point that could be of tremendous help to business is the apparent approval by the Council of the "stop, look, and listen" attitude of the Congressional committees handling the tax policy. Such an attitude can not do us any harm, and could easily do us a lot of good.

In closing, let us look at the situation which faces those who formulate our tax policies. Today, we have financial burdens and obligations undreamed of ten years ago. The budget for servicing the federal debt, veterans administration, defense, or European recovery alone exceed our total budget for any year in the 1920's. These, added to the greatly increased cost of conducting the expanded government functions at home, particularly our social security program, *makes any attempt to correlate present day fiscal policy with our past history invalid.* Any really appreciable cut in federal expenditures can come only by eliminating or so completely reducing one of the aforementioned programs as to sound its death-knell.

It is evident then that the situation is not one capable of an easy solution, not is it one in which the requirements of current business conditions can be ranked above those of our defense and foreign policies. Nevertheless, we should not slacken our efforts in the fight for a sensible tax policy—one which will allow us to keep alive the free enterprise system so necessary to our national existence.

In failing to recognize the current business climate, our tax policy stifles those businesses dependent on retained earnings for growth, and those of highly fluctuating earnings. The development of legitimate business practice should be followed by tax laws sponsoring and protecting such practices. It is a distinct threat to our free enterprise system for our tax policy to endanger the life of a going business, or to prevent the birth of a new one.

Our type of economy places a premium on work and on making full use of our productive capacity, therefore anything in the tax laws or regulations which prevents full use of earning capacity definitely retards progress in this country.

As that eminent tax authority, Roswell Magill, said in the December, 1948, "Tax Review," "To flourish, business need ask no favors from government, but it must have a fair chance to move forward. The tax toll must not be so heavy as to stop the traffic, and the toll gate must be wide enough to permit vehicles to pass through."

CHAIRMAN DIXON: Thank you, Mr. Siddall, for a very fine paper. In introducing the next speaker, I can't refrain from pointing out the fact that he is a Philadelphia lawyer. However, he is here because he is also a well known lecturer on taxation at the Dickinson Law School. He has also lectured on taxation at the Institute of Federal Taxation, and at New York University, and Penn State College.

He is also an author, being a frequent contributor to tax periodicals. His two volume work entitled *Estate Planning and Estate Tax Saving* has gone through several printings, the last revised edition having been published in 1948.

I take great pleasure in introducing Mr. Edward N. Polisher who is going to speak on "Current Tax Developments." Mr. Polisher.

CURRENT TAX DEVELOPMENTS

By EDWARD N. POLISHER[1]
Attorney, Philadelphia, Pennsylvania

I

INTRODUCTION

The Federal Income Tax Law was first enacted by Congress in 1914, the Estate Tax in 1916, and the present Gift Tax in 1932. As a system of jurisprudence, Federal taxation is thus a matter of recent origin when compared with the venerability of the common law, the civil law, and other established legal codes.

The Federal tax pattern is in a fluid and formative state. Its development is being shaped and constantly changed by the Congress, the Courts, and the Treasury Department through its regulations and rulings. The cumulative actions of these agencies during any year affect deeply the course of development and the incidence of Federal taxation. During the past year, however, the velocity of change has been accelerated. As a result, it has been a period of significant and extraordinary changes in the law of federal taxation. The Congress, the Courts, and the Treasury Department have each made their contribution to these developments.

II

INCOME TAX DEVELOPMENTS

REVENUE ACT OF 1948

The 1948 Revenue Act was enacted by Congress over presidential veto on April 2, 1948. Its outstanding income tax feature was the adoption of the split-income technique in the taxation of the income of married persons. Prior to its passage, husbands and wives residing in community property states enjoyed a distinct income tax advantage over those resident in common law states. In community property states, the income of either spouse during coverture was considered to have been earned by both and was therefore divisible between them for income tax purposes. Since the surtax rates under Federal Income Tax law are progressive, the income,

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when divided between husband and wife and taxed separately, one half to each of them, resulted in less income tax than in a common law state where the entire income was taxable solely to the spouse who earned it. To eliminate this discrimination, which was based upon the mere fortuitous, geographical residence of the taxpayer, and to equalize the burden of Federal income taxation among all the residents of these United States, the 1948 Revenue Act allowed all husbands and wives, wherever resident, to divided their combined incomes. It should be noted, however, that the splitting of income for tax purposes does not create any new property rights in the nonearning spouse to that part of the income attributable to such spouse. Regulations governing the filing of joint returns under the new act have been promulgated and now appear in Reg. 111, Sec. 29.51-1 (b).

SUPREME COURT DECISIONS

1. *Forgiveness of Indebtedness*—There have been a number of significant decisions by the Supreme Court of the United States during the current session. In Commissioner vs. Jacobson, 336 U. S. 28 (1949), the Court severely revised and restricted the test for the taxability of income resulting from a reduction of indebtedness. A proper understanding of the implications of this decision calls for a spot of background.

In 1931, the Supreme Court decided, in United States vs. Kirby Lumber Co., 284 U. S. 1, that open market purchases of its own bonds by a solvent corporate taxpayer for less than the amount due resulted in the realization of income.

In Helvering vs. American Dental Co., 318 U. S. 322 (1943), the Court significantly modified the scope of the Kirby decision. There, a corporate taxpayer, presumably solvent, compromised its liabilities for unpaid rent and interest on notes for less than the amount owing, as a result of direct negotiations with its creditors. The Court held that no income was realized by the debtor by this reduction of its indebtedness.

Extending the rationale of these decisions, the test subsequently developed by the lower courts to determine whether taxable income was realized from the acquisition by the debtor of its bonds or other evidences of indebtedness for less than their due amount was: (a) whether the purchase had been made in an open market—that is, through brokers—in which event taxable gain was realized; or (b) whether the purchase had been made by the debtor as a result of direct negotiations with the creditor, in which event no taxable gain would result.

The Jacobson case involved both such situations. The taxpayer, in straitened financial circumstances but solvent, repurchased at various times some of his personal bonds for less than the amounts due thereon. In some instances, the taxpayer purchased the bonds from the owners directly; in others, the acquisitions were made through a bondholders committee, or through a broker. In either case, however, the bondholder knew that the taxpayer was the purchaser.

The Tax Court, following the theory of the Kirby and the American Dental Co. decisions, held that in respect of the bonds purchased directly by the taxpayer, no taxable income resulted; but, as to the bonds purchased through agents, taxable income was realized.

In its opinion, the Supreme Court eliminated this distinction and severely limited the principle which many had believed was implicit in the American Dental Co. decision. It held that in either event, taxable income was realized because the transactions were all sales by which each bondholder sold his entire interest in the bond for the best price obtainable; that there was no intention to transfer part of the claims for cash and to make a gift to the debtor of the balance, which had been found to be the fact in the American Dental Co. case.

The test now seems to be whether there was a specific intent on the part of the creditors to "sell" a portion of the claim for cash and to forgive the balance gratuitously. The transaction must not have the effect of a sale at the highest price available. The further application of the American Dental Co. case, if any, must be limited to open account indebtedness, and claims for rent or interest, in contrast to bond issues.

When bonds are purchased by the debtor for less than face value, when is income realized? Another recent decision held that income was realized upon the purchase of the bonds, even though the bonds remain uncancelled for a long period because of a valid business reason: Commissioner vs. Pittsburgh & West Virginia Railway Co., —F. (2d) — (CCA-3, 1949).

2. *The Sansome Rule*—In another decision, the Supreme Court modified the doctrine of Commissioner vs. Samson, 60 F. (2d) 931 (CCA-2, 1932), cert. den. 287 U. S. 667 (1933). The Sansome rule, as it has become popularly known, was intended to cope with the following situation. A corporation with a substantial surplus of undistributed earnings sought to avoid the distribution of such earnings in the form of taxable dividends. A tax-free reorganization was arranged under which its entire assets, subject to liabilities, would be transferred to a new corporation in exchange for its stock. The successor corporation thereafter would distribute to its stockholders the accumulated funds acquired by it from its predecessor. Since this property was received in exchange for stock, it was contended that it was capital in nature and, therefore, not taxable income.

The Circuit Court held, however, that the accumulated earnings of the predecessor became earnings of the successor corporation in a tax-free reorganization; and that a distribution of such earnings resulted in a taxable dividend.

The Sansome rule seemed to be based upon the fact that there was a continuity of the business venture. If this were correct, the converse would also be true. Thus, if a predecessor corporation had a deficit, such deficit could be used to reduce the successor's corporation's earned surplus. The Supreme Court has rejected this corollary.

In Commissioner vs. Phipps, — U. S. —, 69 S. Ct. 617 (1949), the parent corporation which had earnings and profits available for distribution, by means of a tax-free merger, absorbed several subsidiaries which had deficits. Thereafter, distributions were made to stockholders which were treated as capital distributions. The issue was whether the deficits of the subsidiaries could be used to reduce the surplus from accumulated earnings of the parent. The court held that they did not. The distribution to stockholders of the earnings attributable to the parent corporation were taxed as dividends. The rationale of the decision was that this was a rule necessary to prevent tax avoidance of corporate earnings of the distributing corporation.

In its opinion, the court did indicate a solution to the problem. It consists of reversing the technique. Instead of merging the deficit-corporation into the surplus-corporation, the latter should be merged into the former. The deficit-corporation must be the survivor. See Harter vs. Helvering, 79 F. (2d) 12 (CCA-2, 1935). This merger procedure reduces just as effectively the earnings of the surplus corporation.

3. *Allocation of Income Between Parent and Subsidiary Corporations* —In another decision, the Supreme Court held that wholly owned subsidiaries, by agreement, cannot allocate their income to the parent for tax purposes.

In National Carbide Corporation vs. Commissioner, — U. S. — (1949), the parent corporation organized several subsidiaries. These were operated under a contract with the parent whereby the subsidiaries paid to the parent all profits in excess of 6 per cent on their outstanding capital stock which was nominal in amount. The subsidiaries were held taxable not only on the 6 per cent retained, but also on the profits turned over to the parent. The Court stated that although a corporation which engages in "business activity" is not taxable on income which it collects as "agent" for its owner, the subsidiaries under the facts were not in this category.

The recent lower court decisions in the income tax field are numerous. We have chosen only those decisions which are of the widest interest.

LOWER COURT DECISIONS

1. *Partial Liquidations*—When is a partial liquidation of a corporation deemed equivalent to the distribution of a taxable dividend under Section 115 (g) of the Code? This has long troubled taxpayers and courts alike. The rule seems to be that where the partial liquidation is prompted by a valid business purpose, it will not be considered a dividend. However, the application of this test has been indefinite. The Tax Court recently furnished an example of a valid business purpose. In Joseph W. Imler, 11 TC-No. 101 (1948) (acq.), a corporation *with earned surplus* was forced to abandon some of its activities as a result of a fire. It used the insurance proceeds to redeem a part of its stock. This distribution was held not to be a dividend because it resulted from a bona fide contraction of business operations and consequent reduction in the capital employed.

Section 115 (g) of the Code received another interpretation by the Tax Court. This section deals with the treatment of distributions by a corporation which are considered equivalent to a dividend. The Estate of Rodman Wanamaker owned all of the stock of John Wanamaker, Philadelphia, a corporation, which in turn owned all of the stock of John Wanamaker New York. Both corporations had large earned surpluses. The estate required funds to pay its debts. It could have obtained these funds by having John Wanamaker Philadelphia distribute its earnings as dividends or by redemption of a portion of its shares. This, however, would have resulted in a substantial income tax. Instead, the estate sold some of its John Wanamaker Philadelphia stock to John Wanamaker New York. The Commissioner sought to apply Sec. 115 (g). The Tax Court decided that a redemption of stock to be classified as a taxable dividend must involve the repurchase of a corporation's *own* stock. Here, however, John Wanamaker New York did not purchase its own stock, but that of the parent corporation. Therefore Sec. 115 (g) did not apply: Trustees Common Stock John Wanamaker Philadelphia, et al. 11 TC 365 (1948), appealed to CCA-3.

Thus, the estate got the money it needed and still owned all of the stock through the parent corporation. This may be an additional reason for operating a business in multi-corporate form.

2. *Sale of Corporate Assets*—Who pays the tax on the gain realized from the sale of corporate assets after liquidation, has been a constant

source of litigation in recent years. Where a corporation sells its assets at a profit and then is liquidated, a double tax results; first to the corporation on the gain from the sale, and second, to the stockholders on the gain over the basis for their stock. Attempts to avoid this double tax have taken two forms. In one, the corporation is first liquidated and then the stockholders sell the assets; in the other, the stock is sold and the buyer then liquidates the corporation.

In the Court Holding Co. Case, 324 U. S. 331 (1945), the Supreme Court cast considerable doubt on the effectiveness of the first technique. It held that where a corporation is liquidated and the sale of the assets received by the stockholders in liquidation follows soon thereafter, the transaction will be subjected to close scrutiny. If the negotiations for sale of the corporate assets were commenced prior to the liquidation, gain resulting from the sale will be imputed to and taxed to the corporation. The taxpayer must show that no negotiations took place on behalf of the corporation for the sale of the property prior to liquidation, if the tax to the corporation is to be eliminated.

Two recent Tax Court decisions indicate exceptions to this rule. In Steubenville Bridge Company, 11 YC-No. 96 (1948), a syndicate, none of whose members was a stockholder, arranged to acquire options to purchase all the stock of a corporation whose chief asset was a bridge. The syndicate then entered into a contract to sell the bridge to the State of West Virginia.

Thereafter, it secured the options, exercised them, liquidated the corporation and then consumated the sale. The Court held no gain was realized by the corporation because the negotiations for the sale of the bridge were not conducted by the corporation but by the members of the syndicate who were not then stockholders of the corporation. The court also stressed the fact that the original stockholders were not aware, at the time they assigned their stock to the syndicate, of the contemplated sale of the bridge; and further indicated that if the negotiations for a sale by the stockholders commence after steps toward liquidation have been taken, the corporation will not be considered as the seller.

An exception even closer to the line results from the decision in Dallas Downtown Development Co., 12 TC-No. 17 (1949). *A*, a corporation, negotiated with *B*, a corporation, for the purchase of the building where *A* conducted its banking business. The acquisition of this property by direct purchase would require an investment in excess of the limit permitted *A* by Texas law. The officers of *A*, therefore, formed a dummy corporation which purchased all of *B's* stock at the price agreed upon for the building, liquidated *B*, created a mortgage on the building, and thus conveyed the property to *A*, subject to such mortgage. The court held that *B* corporation realized no taxable gain from the disposition of the building. It is apparently immaterial that the negotiations were for the sale of assets and that the stock was purchased for the purpose of acquiring these assets by an immediate liquidation of the corporation.

Both these decisions seem inconsistent with the realistic approach of the Court Holding Co., supra, and their fate on appeal should be watched with interest.

3. *Stockholder Advances to Corporations*—Where a taxpayer advances money to a corporation which later becomes defunct, two questions usually arise with respect to the taxpayer's deduction for such loss. The first, whether the advance was an additional capital contribution or a debt; the second, if it is a debt, was it a business or a nonbusiness bad debt. If the advance is deemed a capital contribution, the deduction is limited to a long-term capital loss under sections 23 (g) and 117 (b) of the Code. On the other hand, should it be construed a debt, it may be a nonbusiness bad debt, in which case the deduction will be treated as is a short-term capital loss (Section 23 (k) (4) of the Code); or it may be a business bad debt, so that the deduction would be allowed in full (Section 23 (k) (1) of the Code).

Whether an advance is a debt or a capital contribution is a problem which arises most often where a stockholder lends money to a controlled corporation. The Commissioner and the Tax Court generally have considered such loans as capital contributions on the theory that there was no intention to create a debt.

In the recent case of O'Neill vs. Commissioner, 170 F. (2d) 596 (CCA-2, 1948) cert. den. — U. S. — (3/28/49), the Circuit Court differed with this approach, although it affirmed the Tax Court's decision. The controlling factor, the Court held, was whether the corporation served a valid business purpose. If so, the dealings between the taxpayer and the corporation should be viewed in the same light as though he did not own or control the corporation. Here, however, the court pointed out the only disclosed reason for creating the corporation was to make it unnecessary for the taxpayer to procure his wife's signature to deeds. This was considered too trivial a reason to constitute a valid business purpose.

The importance of the case rests on the new approach recommended by the Circuit Court where advances are made by stockholders to controlled corporations which have a valid business purpose.

Whether the debt is a business or nonbusiness bad debt has been before the Courts in two recent cases: Valentine E. Macy, Jr., 8 TCM 45 (1949), and Maloney et al vs. Spencer, — F. (2d) — (CCA-9, 1949).

In the Macy case, the finding of a business bad debt was predicated on the taxpayer's promotional activities. The Court found that the taxpayer maintained a separate office through which he looked after his interests in numerous and varied enterprises, including real estate, publishing, coal, cotton, railroads, petroleum, etc.

In the Spencer case, the court found that the taxpayer, who was the sole stockholder in three corporations, organized to carry on fruit and vegetable packing and canning, was engaged in the business of acquiring and leasing food processing plants, and that the loss was a proximate incident of the leasing.

4. *Unreasonable Accumulation of Surplus*—The Tax Court recently handed down a liberal decision which has been acquiesced in by the Commissioner in respect of the application of Section 102 of the Code which imposes a penalty on corporations for unreasonable accumulation of surplus.

In the J. L. Goodman Furniture Co., 11 TC 530 (1949), (acq.), the stock of a retail furniture store was owned 90 per cent by a family group and 10 per cent by other stockholders. The company had cash, government obligations and other securities of approximately $920,000. The company's average yearly earnings amounted to $125,000 and annual dividends were paid in the sum of $36,000. Since 1935, the company had planned to open one or two additional branches, which the president personally estimated would cost $500,000, but the threat of war and later the war itself, prevented such expansion. No other evidence, such as building estimates, etc., was introduced. Land for this purpose was not acquired until 1947. The Tax Court, nevertheless, held that the earnings were being reasonably accumulated for business purposes.

It is yet too early to determine whether this decision indicates a more liberal approach by the Tax Court to Section 102 problems. In the past, the courts have generally refused to place much weight on nebulous plans for expansion, unless the taxpayer could show specific steps taken in that direction and cost estimates based on something more than the mere opinion of the corporate officers.

5. *Reasonable Compensation*—The abrogation of the Dobson rule by Congress has afforded taxpayers another opportunity for relief in unreasonable compensation cases. The presumption of correctness, which surrounds the Commmissioner's determination, imposes on the taxpayer the burden to produce evidence supporting the reasonableness of the salaries involved. As a practical matter, what the Tax Court has been doing is to

act as a sort of arbitrator and to fix reasonable compensation usually at a figure somewhere between the salary determined by the Commissioner and that contended for by the taxpayer. So long as the Tax Court's finding had a reasonable basis in fact, the Circuit Court felt themselves foreclosed by the Dobson rule from reviewing such decision. In several recent cases, however, the Circuit Courts have adopted a more positive attitude.

In The Roth Office Equipment Company vs. Gallagher, 172 F. (2d) 452 (CCA-6, 1949), the total salaries paid to four officers amounted to $74,000. The Commissioner allowed $41,000 and the Tax Court set the salaries at $61,000.

In Wright-Bernet, Inc. vs. Commissioner, 172 F. (2d) 343, (CCA-6, 1949), the officers received $86,000 in salaries. The Commissioner allowed $51,000 and the District Court $68,000.

In both cases, the taxpayers introduced evidence that the salaries paid were comparable to those paid to similar employees throughout the industry. The Commissioner submitted no evidence to refute the reasonableness of salaries paid.

The Sixth Circuit reversed both lower courts and allowed the salaries in full. It held that the lower courts cannot reduce the amount of salaries actually paid where qualified witnesses testify to their reasonableness and such evidence is not contradicted by the Commissioner.

Ordinarily, where the Commissioner disallows part of the compensation paid to officers, the corporation gets no deduction for the portion disallowed, but the recipient of the salary nevertheless pays tax on the full amount as income. A recent case indicates one way to avoid this double tax. In Willis W. Clark, 11 TC 672 (1948) (non-acq.) appealed to CCA-6 (2/28/49), the corporation entered into an agreement with its president prior to the close of the taxable year 1942, limiting his salary and bonus for the year 1941, to the amount which would be allowed by the Commissioner as a deduction to the corporation. The officer gave the corporation his promissory note for the difference between the amount agreed upon between the Revenue Agent and the corporation as reasonable compensation and the sum actually paid to him in 1941 and 1942 for his 1941 services.

The court held that the officer was not taxable in 1942 on that portion of the compensation which, prior to the close of the taxable year, he agreed to return to the corporation.

6. *Sale of Business-Goodwill*—A troublesome problem in the sale of a going business is the tax implications of gain resulting from the transfer of its goodwill.

A sale of a going business involves the transfer of its several component parts, some of which are capital assets under Code Sec. 117 (a) (1), the gain from whose sale is treated as capital gains; others, such as property held for sale to customers in the ordinary course of trade or business, are not capital assets and any profit realized on their sale is treated as ordinary issue. Goodwill is considered a capital asset. In preparing the instruments of sale, care must be taken, however, to clearly identify each element transferred and to allocate part of the total price paid for each; otherwise, the courts may refuse to recognize that any part of the price was attributable to the sale of goodwill. This is illustrated in two recent cases.

In Grace Bros., Inc. vs. Commissioner, — F. (2d) — (CCA-9, 1949) aff'g. 10 TC 158 (1948), the taxpayer sold its entire stock of wine, barrels, labels, and list of customers. It did not sell its plant but instead leased it to the buyer. The Tax Court determined the entire gain to be ordinary income because the transaction was merely a purchase of stock-in-trade and other assets and did not constitute a transfer of the goodwill of the business. It stressed the fact that from the agreement of sale it did not appear that the business was transferred as a "unitary whole." The Ninth Circuit in affirming the Tax Court's decision noted that the written instruments relating to the sale nowhere mentioned the element of goodwill.

In Violet Newton, 12 TC-No. 30 (1949), the same question was considered with similar result. In that case, the taxpayer sold a pinball machine distributing business. The agreement of sale recited the assets sold as consisting of inventory, accounts receivable, credit deposits, goodwill, and the right to use the firm name. No allocation in the selling price had been made for the tangible and intangible assets sold. The taxpayers urged that the entire gain resulted from the sale of intangibles such as goodwill, location, etc. The Tax Court held that insufficient evidence was presented to establish a selling price for goodwill.

In the light of these cases it would seem prudent that in the sale of a going business, the capital assets should be specifically referred to and the part of the price allocable to such assets set forth.

7. *Entity Theory of Partnerships*—Conflict exists in the law with respect to whether a partnership should be regarded merely as an association of individuals who are co-owners of the partnership property, or as a separate legal entity distinct from the partners who compose it. Each status involves important tax consequences. Generally, the Tax Court has favored the entity theory and has held that a sale by a partner of his partnership interest results in capital gain, irrespective of the nature of the assets owned by the partnership. Commissioner vs. Lehman, 7 TC 1088 (1946), aff'd. 165 F.

(2d) 383 (CCA-2, 1948), cert. den. 334 U. S. 819 (1948). The Second Circuit, in affirming this decision also seemed to approve of the entity theory. The Fifth Circuit adopted the same rationale in Commissioner vs. Smith, — F. (2d) — (CCA-5, 1949), aff'g. 10 TC 398 (1948). In a recent decision, however, the Second Circuit apparently abandoned this theory.

In Commissioner vs. Whitney, 169 F. (2d) 562 (CCA-2, 1948) cert. den. — U. S. — (1948), a partnership whose partners controlled a corporation, sold its assets to the corporation. The assets included securities some of which were transferred at a gain and others at a loss. The Commissioner included the gains in the partner's net income, but denied, under Section 24 (b) of the Code, the losses as arising from a sale between related parties. The Tax Court conceding that the loss would have been disallowed, if the sale had been made by the individual partners, nevertheless permitted the loss on the ground that the partnership entity was not an individual within the meaning of Code section 24 (b). In reversing the Tax Court, the Second Circuit held that the purpose of this section of the Code was to prevent loss deductions where a taxpayer retained the benefits of ownership after sale; and this could not be circumvented by mere legal technicalities.

8. *Bargain Sale to Partnership Stockholders*—The entity theory of partnerships was also involved in a recent case dealing with a bargain sale to stockholders.

Where a corporation sells its assets to stockholders at less than their market value, the difference is deemed a taxable dividend, to the extent that the corporation has earnings and profits. Does the same rule apply where the assets are sold to the stockholders as a partnership? This was the issue in Shunk vs. Commissioner, — F. (2d) — (CCA-6, 1949).

A trust taxable as a corporation sold its assets at book value to a partnership composed in part of beneficiaries of the trust. The partnership then continued the business. The Commissioner determined that the difference between the amount paid for the assets and their market value, including goodwill, was taxable as a dividend. The Tax Court agreed (10 TC 293 (1948)). On appeal, the Sixth Circuit reversed. It held that the sale was not to the beneficiaries but to the partnership, a separate entity which must be recognized.

The entire issue reflects the conflict between legalistic approach and the realistic appraisal of the economics and benefits flowing from such transactions. The latter rationale is that which is usually employed in determining the incidence of Federal taxation.

9. *Family Partnerships*—The Supreme Court has again decided to review the income tax implications of a family partnership. When the Tower (327 U. S. 280 (1946) and Lusthaus (327 U. S. 295 (1946)) decisions were announced, many tax experts held to the opinion that they sounded the death knell of the ordinary family partnership. However, an impressive line of taxpayer victories followed in the Circuit and District Courts, and to a lesser extent, in the Tax Court. The Commissioner took cognizance of this development in appealing to the Supreme Court the Fifth Circuit Court's decision in Culbertson, Sr. vs. Commissioner, 168 F. (2d) 979 (CCA-5, 1948). In his petition for certiorari, the Commissioner complained that the decision "reflects an alarming tendency by some of the Courts of Appeal to circumvent" the Tower and Lusthaus cases. The Supreme Court granted certiorari on December 6, 1948.

In the Culbertson case, a father purchased his partner's interest, and pursuant to the dissolution agreement, formed a new partnership with his four sons. The sons gave notes to the father for their shares, which were repaid in part out of the profits of the business, the balance being cancelled as a gift. All four sons entered the military service shortly after the formation of the partnership and hence did not render any services. Thus, in effect, they contributed neither capital nor services. Nevertheless, the Fifth Circuit reversed the Tax Court and recognized the partnership for income tax purposes. The Court held that the primary test is the reality or bona fides of the transaction. Contributions of capital and services are merely circumstances to be considered in determining the actuality of a family partnership.

10. *Sales of Real Estate*—A tax problem which is difficult, because it precludes, by its very nature, the application of definite standards, is the determination of whether a person who engages in the sale of real estate is an investor or a dealer. Where the seller is merely an investor, the profit on such sales is taxed as a capital gain under Code section 117. If he is a dealer, the profit on such transactions is ordinary income. The more common tests applied by the Courts are the number and frequency of such sales and the original purpose for which the property was built or acquired.

Elgin Building Corporation, 8 TCM 114 (1949) involved this issue. There, the taxpayer, a corporation, engaged in the building of defense housing under Title VI of the National Housing Act. Some of the houses were constructed for rental purposes, others were immediately sold after construction without ever having been rented. Those properties which were rented, the Court held to be capital assets under Sec. 117 (j) of the

Code and the profit realized on their sale was capital gain. With respect to those houses which were never rented, but were immediately sold, the court considered the frequency and regularity of such sales and concluded that they were constructed and held primarily for sale to customers. Therefore, the gain on their disposition was ordinary income.

11. *Constructive Receipt*—The constructive receipt doctrine has long been used by the Commissioner as a spear to prevent tax avoidance. Recently, the First Circuit, in an important decision written by Justice Frankfurter, specially presiding, held that the same theory can be used as a shield by the taxpayer.

In Ross vs. Commissioner, 169 F. (2d) 483 (CCA-1, 1948), the taxpayer, in 1932, became entitled to amounts as salary which were earned and had been accrued on the corporation's books for that year. Instead of withdrawing the sum due him in that year, which he could have done, he took it in 1941. He did not report such salary as income. The Commissioner sought to tax the amounts received as income in the year 1941. The taxpayer contended that the salaries had been constructively received in 1932 and were taxable in that year. The Statute of Limitations, of course, barred any deficiency for the latter year. The Commissioner took the position that the concept of constructive receipt was available to him only to prevent tax avoidance. The Circuit Court held, however, that the doctrine is a mandatory rule of law; and the mere failure to report such income in the year it was constructively received does not render it taxable in the subsequent year of actual receipt.

The Commissioner advanced the novel argument that the taxpayer had an election to defer the tax to 1941, and his failure to report it in 1932 constituted an election to have it taxed in the year of receipt. The Court disagreed and held that a choice is not binding where the taxpayer has adopted the wrong method and where such a choice is not accompanied by fraud or misrepresentation.

12. *Deductions for Illegal Expenditures*—The profits from illegal enterprises have always been includible in gross income for tax purposes. This rule has been a powerful weapon in the hands of the Treasury in the prosecution of racketeers against whom it was difficult to produce evidence of crime. The converse of this proposition, however, is not necessarily true. The Commissioner has consistently resisted the allowance of deductions for illegal expenditures.

The justice of this rule, however, is open to question, especially where legitimate businessmen were forced, because of economic conditions, to pay over-ceiling prices for goods during the war and postwar period. In I. T. 3724, C. B. 1945, 57, the Internal Revenue Bureau ruled that the cost of goods in excess of the OPA ceiling prices is not deductible.

In the recent case, Lela Sullenger, 11 TC-No. 127 (1948), the Tax Court, however, drew a distinction between ordinary deductions and allowance for cost of goods sold. It pointed out that under the Constitution, taxable income cannot be determined without taking into account the cost of goods sold. The Court rejected the Commissioner's position and held the entire cost, including the amount paid in excess of the OPA ceiling price, deductible.

On the other hand, deductions for amounts paid in compromise of an anti-trust penalty, and payments to underworld characters for services in labor union negotiations, were disallowed in two recent decisions as being against public policy: Universal Atlas Cement Co. vs. Commissioner, 171 F. (2d) 294 (CCA-2, 1948) cert. appl. 3/15/39; Excelsior Baking Co. vs. United States, 82 F. Supp. 423 (D. Ct. Minn., 1949).

13. *Charitable Foundations*—The charitable foundation is becoming an increasingly attractive instrument for accomplishing tax savings. This development was given added impetus by the recent Circuit Court opinion in Commissioner vs. Edward Orton, Jr., Ceramic Foundation, — F. (2d) — (CCA-6, 1949), which affirmed the Tax Court's decision. There, the decedent, who was engaged in the manufacture and sale of pyrometric cones, provided in his will for the creation of a foundation to which his going business was to be transferred, and that the foundation was to operate the business and devote its income to the study and promotion of the science of ceramic engineering. From the business income, his wife was first to be paid a substantial annuity for life. The annuity amounted to about 30 per cent of the total income of the business over a ten year period. The Court held that the income of the business was exempt from income tax under Sec. 101 (6) of the Code; that it is not the source of the income but its ultimate destination which determines whether the foundation is organized exclusively for charitable purposes; that it makes no difference that the foundation was established in the same instrument which transferred the business and created the annuity to the wife; that the annuity was a contractual obligation which had to be discharged to make the funds available for the scientific aims of the foundation.

14. *Taxation of Annuities*—The Internal Revenue Bureau has recently amended its regulations to provide that the 3 per cent rule for the taxation of annuities will not apply to installment payments under

endowment policies and annuity contracts, unless such payments are true technical annuities—that is, those which are computed with reference to the life expectancy of the annuitant according to the mortality tables. The new Bureau ruling, T. D. 5684, effective February 13, 1949, amends Regulation 111, Sec. 29.22 (b) (2)-2. In effect, it adopts the rule announced by the Tax Court in Thornley, 2 TC 220 (1943) as to which the Commissioner had originally filed his nonacquiescence. Under the new rule such installment payments will not be taxable until the taxpayer has completely recovered his premium payments.

15. *Alimony*—Alimony paid in the form of "installment" payments to discharge an obligation of a specified principal sum is not deductible by the husband nor taxable to the wife for income tax purposes, unless the payments are to be made over a period of more than 10 years. (I. R. C. Sec. 23 (k)). On the other hand, "periodic" payments in discharge of an alimony obligation, having no relation to a fixed principal sum, are deductible by the husband and taxable to the wife, without regard to the 10 year requirement. These rules are rather strictly applied by the courts.

In a recent case, alimony payments were set at $100 per month for a period of 50 months, unless the wife sooner remarried, (Frank R. Casey, 12 TC-No. 33 (1949)). However, the decree also expressly provided that such payments were to be regarded as "periodic" and that the wife was to pay the Federal income tax on those amounts. The Tax Court decided that such payments were in reality "installment" payments and that the language of the divorce decree was not determinative of the incidence of Federal income taxation.

16. *Fraud Penalties Against Decedents* — Until the issuance of G. C. M. 22326, C. B. 1940-2, 159, the Treasury had taken the position that the 50 per cent civil fraud penalty could not be asserted after the taxpayer's death. This was based on the rationale that such penalty was in the nature of an ex delicto claim and, in the absence of any Federal statute relating to its survival, would abate with the death of the tort-feasor. G. C. M. 22326 completely reversed the Treasury's rule. Drawing from dicta of the Supreme Court in Helvering vs. Mitchell, 303 U. S. 391 (1938), the G. C. M. declared that fraud penalties are not penalties because htey involve no element of personal punishment, but are rather remedial in nature and intended to reimburse the government for loss resulting from taxpayer's fraud and expense of investigation.

The first judicial decision to rule squarely on this point since G. C. M. 22326 recently came from the Tax Court. In Estate of Louis L. Briden, deceased, 11 TC-No. 131 (1948), the decedent's estate was held liable for the 50 per cent fraud penalty under Section 293 (b) of the Code, despite the fact that notice of deficiency assessment was not issued until after decedent's death.

III

Estate Tax

1948 REVENUE ACT

The amendments made to the Federal estate tax statute by the Revenue Act of 1948 represent the most recent effort of Congress to bring about an equality in the burden of such taxes between the estates of decedents who resided in community property states and those of common law states. The development of this process of equalization presents an interesting narrative.

In community property states, each spouse owns a half-interest in the community property. Generally, such property consists of earnings and property acquired by either spouse during coverture, irrespective of which spouse holds title. Prior to 1942, upon the death of a spouse, only his one-half interest in such property, which he had the right to dispose of by will, was subject to Federal estate tax. The other one-half, being the property of the surviving spouse under the law of community property states, did not form part of the estate of the deceased spouse; and was not subject to tax until the death of the surviving spouse. On the other hand, in common law states, neither spouse had an undivided interest in the property of the other during the lifetime of both. Upon the death of the spouse owning the property, or the death of the earning spouse where the property was jointly owned by both spouses, the entire amount thereof was subject to Federal estate tax.

Since the estate tax is imposed at sharply progressive rates which increase in the respective brackets as the size of the estate mounts, the result was that substantially lower estate taxes were assessed against estates of decedents in community property states than were assessed on estates of similar size in common law states.

The Congress in 1942, by amendment of the Federal estate tax law, attempted to eliminate this discrimination against the estates of decedents who died residents of common law states.

The amendments of that year provided that the entire community property should be included in the decedent's gross estate, except such portion as could be shown to have been received as compensation for personal services actually rendered by the surviving spouse, or derived originally from such compensation, or from separate property of the surviving spouse. Thus, as in common law states, the entire community property was taxable to the first spouse to die unless some portion of the community was economically attributable to the surviving spouse. A further provision stated that there should be at least included in the estate of the decedent so much of the property over which such deceased spouse had a power of disposition at death.

The 1948 Revenue Act repealed the community property provisions inserted in 1942 and restored the taxability of community property to its pre-1942 status. It created, also, the marital deduction for estates of decedents who resided in common law states. However, the pattern for the includibility of property in the decedent's gross estate is not disturbed. The same types of property which formed part of the decedent's gross estate for Federal estate tax purposes prior to the 1948 Revenue Act continue to be subject to the tax on and after January 1, 1948, as of which date the new Estate Tax amendments became effective.

An additional deduction was added to the Estate Tax statute by a new section of the Code known as Sec. 812 (e). Under it, a decedent-spouse is allowed a marital deduction from his gross estate in an amount equal to the value of all interests passing from the decedent to the surviving spouse under certain conditions. The deduction, however, is limited to an amount not in excess of 50 per cent of the decedent's adjusted gross estate. Community property is generally not available for the marital deductions and is given special treatment.

To qualify for the marital deduction, the interest in property passing to the surviving spouse must either pass outright or by means of a trust. If it passes in trust, the following conditions must be met:

1. The surviving spouse must be entitled for life to all the trust income which must be distributed annually or at more frequent intervals. Thus, trusts under which the income is to be accumulated, or may in the direction of the trustee be accumulated and not distributed, will not qualify for the marital deduction.

2. The surviving spouse must have the power, either during life or at death, or both, to appoint the entire corpus free of the trust to herself or in favor of her estate.

3. The surviving spouse must have the right to exercise this power alone and in all events.

4. If any person other than the surviving spouse has the power to appoint any part of the trust corpus, such power must be exercisable only in favor of the surviving spouse.

The 1948 Revenue Act failed to deal adequately with the peculiar problems which life insurance presented. Congress soon thereafter, on July 1, 1949, adopted a Joint Resolution amending Sec. 812 (e) (1) (G) of the Code relating to life insurance with power of appointment in the surviving spouse.

This Resolution provided that where the proceeds under a life insurance, endowment, or annuity contract, are held by the insurer and made payable to the surviving spouse in installments, or where such proceeds are held by the insurer subject to an agreement to pay interest thereon to the surviving spouse, such proceeds will qualify for purposes of the marital deduction, if the following conditions are met:

1. The installments of interest payments must be payable annually or at more frequent intervals commencing not later than 13 months after the decedent's death.
2. All amounts payable during the life of the surviving spouse must be payable only to such spouse.
3. The surviving spouse must have the power to appoint all amounts payable either to herself during her lifetime or to her estate, or both.
4. This power of appointment must be exercisable by the surviving spouse alone and in all events.

The extent to which the marital deduction should be employed will largely depend upon a comparison of the estates of both spouses. It should be remembered that to the extent that a surviving spouse receives property from a deceased, tax-free, by virtue of the marital deduction, it will be taxable in her estate if she still owns it at the time of her subsequent death.

The Treasury Department on May 18, 1949, issued estate and gift tax regulations to implement the changes made by the 1948 Revenue Act. Generally speaking, these regulations are liberal. Thus, with respect to the question of the type of trusts which will qualify for the marital deduction, the regulations provide that the trustee may be given all the usual powers necessary for administering the trust; and provided, further, that they do not operate to deprive the surviving spouse of the beneficial enjoyment during life, which the principles of the law of trusts accord to such a beneficiary. Spendthrift provisions are permissible and the income can even be accumulated, so long as it is subject to the wife's power to request distribution annually.

SUPREME COURT DECISIONS

1. *Pre-1931 Trusts with Income Retained*—The recent Supreme Court decisions on Federal Estate Tax have indeed been significant and precedent-shattering. In Commissioner vs. Estate of Church, 335 U. S.

632 (1949), the Court overruled its own decision in May v. Heiner, 281 U. S. 238 (1930).

In May v. Heiner, supra, the Supreme Court held that a transfer, in which the decedent reserved the income for life, was not taxable as a transfer intended to take effect in possession or enjoyment at death under Sec. 302 (c) of the Revenue Act of 1926—now Sec. 811(c) of the I. R. C. As a result of this decision, Congress enacted the now famous Joint Resolution of March 3, 1931, amending the relevant section of the statute to specifically include such property. Subsequently, in Hassett v. Welch, 303 U. S. 303 (1938), the Supreme Court decided that the amendments made by the Joint Resolution could not be applied to transfers made before March 3, 1931, even though the transferor died after that date.

The rules of May v. Heiner and Hassett v. Welch became firmly imbedded in Federal Estate tax law and were recognized in the Commissioner's own regulations.

In fact, the Commissioner, in appealing the Church case, supra, to the Supreme Court, raised only the question whether the possibility of reverter present in the case was sufficient to cause the transfer to be includible in the estate of the decedent. He did not contend that the pre-1931 transfer was taxable because of the retention of income.

The Supreme Court, however, took advantage of this opportunity to state, in the Church Estate opinion, that in the light of its decision in Helvering v. Hallock, 309 U. S. 106 (1940), May v. Heiner, supra, was no longer correct; and held further that pre-March 3, 1931, transfers with income retained are includible in the estate of the transferor for Federal estate tax purposes.

The Commissioner has now proposed amendments to the Estate Tax Regulations to conform to the change in the law made by the Church Estate decision. The proposed regulations state that the rule announced in the Church Estate will not be applied retroactively, with respect to decedents who died on or before January 17, 1949, the date of the Supreme Court's decision.

2. *Possibility of Reverter by Operation of Law*—On the same day, the Supreme Court handed down its decision in Estate of Spiegel vs. Commissioner, 335 U. S. 701 (1949), a companion case to Commissioner vs. Estate of Church, supra. The Court sought to resolve unequivocally all the troublesome questions of the state tax implications of the remote possibility of reverter by operation of law.

In Helvering vs. Hallock, 309 U. S. 106 (1940), the Supreme Court held that a transfer in trust, with the express proviso that the corpus should revert to the grantor in the event he survived the beneficiaries, was includible in the grantor's gross estate at death under the "possession or enjoyment" provision of Sec. 811 (c) of the Code.

Since that decision, the Commissioner has repeatedly sought to extend the Hallock doctrine to include reverters arising, not only by the express language of the trust instrument, but also those which could come into existence only by operation of law. The decisions of the lower courts on this issue were hopelessly in conflict.

The Spiegel case resolved this conflict by holding that all reverters, whether express or by operation of law and irrespective of remoteness, would cause the transfer to be includible in the gross estate under Sec. 811 (c) of the Code.

The Spiegel case demonstrates how remote a possibility of reverter by operation of law can be and yet result in the taxability of the entire trust corpus. There, the decedent transferred property in trust, with the income payable to his three children during his lifetime, or, if they did not survive him, to their surviving children. The corpus was distributable in the same manner. No specific provision was made in the event the decedent outlived his children and grandchildren. Actually, the grantor was survived by his three children and grandchildren. Under local law, the trust corpus would have reverted to the grantor, had he survived his children and their issue.

It is interesting to note, as one of the dissenting opinions points out, the court's decision sustained a tax of $450,000 because of a remote possibility of reverter which had an actuarial value of $70 at the time of the grantor's death.

On April 15, 1949, the Treasury issued proposed amendments in its Estate Tax Regulations to conform with the Church and Spiegel decisions. They provide that a right to the possession or enjoyment of the property or a right to the income therefrom constitutes a right or interest in the property. This provision reconciles the Regulations with the Church decision.

Another proposed change is in one of the examples under Section 81.17 of the Regulations. An entirely new example is substituted for example 6, which indicates that if the decedent has parted with every right and interest in the property, no part of the property will be includible in the decedent's gross estate.

The effect of the Spiegel case is to be seen in Estate of Merritt J. Corbett, 12 TC-No. 22 (1949). There, the decedent created a trust with the income payable to his wife so long as she remained married to him, and upon his death, the income was to continue to be paid to her for the remainder of her life. In the event she ceased to be his wife, the income was to be paid to him. Certain remainder interests were also created over which the decedent retained the right to change beneficiaries. There was no doubt that the remainder interests were includible. The question was whether the value of the wife's life estate was also includible. The Tax Court, relying on the rationale of the Spiegel case, held that it was; that the wife's life estate depended on the contingency of her surviving the decedent and the contingency ended only with the decedent's death. Therefore, the life interest did not fully vest in the wife until that time.

Some attempts to circumvent the effect of the Spiegel decision have already been made. Thus, Minnesota enacted a law (Ch. 201 Minn. Laws of 1949) to the effect that no reversionary interest is to be deemed to exist, if the settlor has manifested an intention to divest himself of all interest in the trust. Instead, the trust fund is to be held upon a resulting trust for the benefit of the State, if all the beneficiaries predecease him.

In Pennsylvania, the grantor of a trust which did not provide for the disposition of the fund in the event he survived all the beneficiaries, petitioned the court to reform the trust deed, asserting that this contingency was not covered, through the inadvertence and mistake of the draftsman, and stating that he now wished to provide that in such event the income should pass to a charity. The Pennsylvania Supreme Court returned the case to the lower court for further evidence with instructions that if the lower court finds that the omission was in fact a mistake or inadvertence, the court may permit the requested reformation. Irish vs. Irish, 361 Pa. 410 (1949). The final outcome is not yet known.

3. *Charitable Remainders as a Deduction*—In another estate tax case, the Supreme Court strongly reaffirmed its own prior decision in Merchants National Bank of Boston vs. Commissioner, 320 U. S. 256 (1943), with respect to deductions for charitable remainders.

Where a remainder interest is given to a charity, its actuarial value is allowed as a deduction for Federal estate tax purposes. The difficulty arises where invasion of the trust corpus is permitted for the benefit of the life tenant. The Courts have held that if the power to invade the corpus can be measured by a clearly defined standard contained in the instrument, the charitable deduction for the remainder interest will be allowed for that portion of the fund which, under all the circumstances, will definitely be devoted to charity. On the other hand, where there is no such standard, the deduction will not be granted.

Thus, in Henslee vs. Union Planters National Bank & Trust Company, 335 U. S. 600 (1949), the decedent created a trust providing for the payment of a stipulated amount per month to his mother for life with remainder interests to charities. The Trustees were given the discretionary power to expend either income or principal for the "pleasure, comfort, and welfare" of the mother, and "in such manner as she may desire." At decedent's death, the mother was 85 years of age with substantial independent means of her own, so that the possibility of corpus invasion was extremely remote. The Supreme Court, nevertheless, held that a deduction for the charitable remainder could not be allowed because the power to invade was not governed by any ascertainable standard. It also commented on the fact that by the terms of the trust instrument, the charitable remainders were subordinated to the decedent's primary concern for his mother. That as a practical matter, the possibility of invasion was unlikely, was immaterial.

4. *Valuation of Remainder Interests*—The valuation of the assets in a decedent's gross estate for Federal estate tax purposes is always fraught with great difficulties. A particularly complex problem arises in valuing remainder interests left to charities. The law is that where life estates are given to specified persons with remainders to charities, the estate is allowed a deduction for the charitable remainder. The difficulty arises in computing the value of the remainder interest where indeterminate factors are present. One of these factors—the power to invade the corpus for the benefit of the life tenant—was previously discussed in connection with the Supreme Court decision in the Union Planters National Bank & Trust Company case, supra. Another factor—the role of life expectancy tables—is highlighted in two recent Tax Court decisions.

In Estate of Nellie H. Jennings, 10 TC 323 (1948), the decedent bequeathed her estate in trust to pay the income to her husband for life with remainder to a designated charity. The husband was 73 years of age at his wife's death. He had been extremely ill the past several years and it was apparent that he would not live as long as the life expectancy table predicted for a man of his age. As a matter of fact, he died within two months. The Commissioner, nevertheless, computed the husband's life interest by reference to the ordinary life expectancy tables. The Court held, however, that actual physical conditions, not life expectancy tables, controlled valuation.

In Estate of Reinhold H. Forstmann, 6 TCM 136 (1947), the decedent provided that the income from a trust be paid to his wife for life unless she remarried, remainder to charity. The Court held that the valuation of the wife's life estate should be based on the American Experience Tables, designed to reflect the possibilities of a woman at that age remarrying.

LOWER COURT DECISIONS

1. *Estate Tax Implications of Deferred Compensation Arrangements* —The use of deferred compensation arrangements has increased substantially in recent years. Recently, there have been several important decisions dealing with the estate tax implications of such arrangements upon the death of the employee.

In Estate of William L. Nevin, 11 TC 59 (1948) (acq.), the decedent was the president of John Wanamaker Philadelphia. To persuade him to resign, the corporation entered into a formal contract with him whereby it agreed to pay him a stipulated pension for a period of ten years. If he died within ten years, the remaining payments were to be made to his widow, if she survived him. The Tax Court held that upon his death, the value of the remaining payments to be made to his widow was includible in his gross estate under Sec. 811 (c) of the Code. The rationale of the court's decision was that the payments were made under an enforceable contract, supported by valid consideration.

The same result was reached in Estate of Paul G. Leoni, 7 TCM 759 (1948).

In Estate of William J. Higgs, 12 TC-No. 43 (1949), the decedent under a retirement pension fund paid for by the employer had the right to elect, prior to retirement, to receive either an annuity for his own life or a smaller survivorship annuity for the lives of himself and his wife. He chose the latter. At his death, the Court held that the value of the widow's survivorship rights were includible in his gross estate under Sec. 811 (c). A dissenting opinion contended that no "transfer" had been made by the decedent, since he exercised his option prior to the time the annuity had vested in him.

On the other hand, where a company voluntarily paid a substantial bonus to an estate of a deceased employee in recognition of his long and faithful services, the Court held that the bonus was not includible in the employee's gross estate, since it was not paid pursuant to any contract. Jack Messing, 7 TCM 568 (1948). Similarly, Estate of Eugene F. Saxton, 12 TC-No. 74 (1949).

In Estate of Emil A. Stake, 11 TC-No. 98 (1948), the decedent employee contributed to an employee's pension fund to which his employer also contributed. He died prior to retirement age (60 years). Under the plan, the employer could either pay a pension to his widow or repay his contributions with interest. The employer elected to pay the pension. The Court held that only the value of the employee's contributions with interest was includible in his gross estate because the decedent, prior to reaching retirement age, had at most an expectancy of a pension for his widow and not a vested right thereto. He had definitely rights only to repayment of his contributions with interest.

The rule would appear to be that if the payments to the widow are made pursuant to a contractual obligation, their value will be includible in the decedent's gross estate. On the other hand, if the payments are made voluntarily by the employer, their value will not form part of the decedent's estate.

2. *Contemplation of Death*—A decedent's age at the time he makes a transfer is of great importance in determining whether the transfer was made in contemplation of death. The factor of advanced years may, however, be overcome by evidence of motives associated with life. In Estate of Oliver Johnson, 10 TC 680 (1948), the decedent died at the age of 90. Four years earlier, he had made a substantial transfer of his property. The Court held that despite his advanced age, the gift was not in contemplation of death. It found that his primary motive was to rid himself of the management of certain properties.

3. *Grantor's Retained Power to Accumulate or Distribute Income*—A power either to accumulate or distribute the current income of a trust had been held to be a power of alteration or amendment which would cause the trust to be includible in the grantor's gross estate at death under Sec. 811 (d) of the Code. This is so because the decedent in exercising such a power could favor the remaindermen as against the life tenants. The cases have held, however, that only the interest of the life tenant which could thereby be affected was includible. A recent decision seems to reveal a tendency to include the entire trust, pursuant to the philosophy of the decision in Estate of Speigel vs. Commissioner, 335 U. S. 651 (1949).

In Commissioner vs. Estate of Hager, — F. (2d) — (CCA-3, 1949), the decedent had retained the power to accumulate or distribute income; and also the power to treat capital gains resulting from the sale of trust assets either as part of income, in which event they would benefit the life tenants, or as corpus, which would insure to the advantage of the remaindermen. The Court considered these powers to be powers of alteration and amendment and held that the entire trust, not only the life tenant's interest, was includible in the decedent's gross estate under Sec. 811 (d).

4. *Power Retained to Remove Trustee as Power to Terminate*—

In another recent decision involving Section 811 (d), the decedent created a trust reserving to the trustee the power to terminate the trust. The decedent, as donor, retained the power to remove the trustee and appoint himself successor-trustee. Thus, he would be in a position to exercise the power of termination. The Court held, in Estate of Paul Loughridge, 11 TC-No. 115 (1948), that the trust was includible in the decedent's gross estate, even though the decedent never became the trustee, so that the power to terminate was not vested in him at the time of his death.

IV

Gift Tax

1948 REVENUE ACT

Prior to the Revenue Act of 1942, residents of community property states enjoyed a distinct Federal gift tax advantage over residents in common law states in respect of the transfer of property by gift.

A gift of community property was taxable as though one half of the value of the gift were the gift of the husband and one half the gift of the wife. In common law states, neither spouse had an undivided interest in the property of the other. Therefore, the entire value of the property was taxable as the gift of the donor spouse.

By the Revenue Act of 1942, Congress attempted to equalize this gift tax burden between residents of community property and common law states. It amended the gift tax law with respect to community property by providing that all gifts of community property were to be considered as the gifts of the husband, except gifts of such property which could be shown to have been received as compensation for personal services actually rendered by the wife, or derived from such compensation originally, or from separate property of the wife which were to be considered as gifts of the wife.

The 1948 Revenue Act repealed Sec. 1000 (d) of the Internal Revenue Code relating to gifts of property held as community property except as to gifts made between January 1, 1943, and April 2, 1948, the date of the enactment of the 1948 Revenue Act.

The repeal of the gift tax provisions in respect of community property restored the pre-1942 gift tax status of such gift. At the same time, the Congress introduced "gift tax splitting" between spouses resident in common law states, which is similar in its effect to the pattern used for income taxes.

Section 372 of the 1948 Revenue Act amended Section 1004 (a) of the Code by adding a new paragraph known as (3) entitled "Gift to Spouse." As in the case of the Federal estate tax, there was introduced into the Federal tax system, for the first time in its history, a marital deduction in computing the net gifts of citizens and residents of the United States. The marital deduction for gift tax purposes is allowed for gifts made after April 2, 1948, the date of the enactment of the 1948 Revenue Act. Gifts of community property, however, are given special treatment.

Under the new law, the marital deduction is an amount equal to one half the value of any gift of an interest in property made to a donee who, at the time of the gift, is the donor's spouse. It is to be determined with respect to each gift to a spouse without regard to the annual exclusion. Thus, if a donor makes a gift to his spouse of $10,000 there will be allowed an annual exclusion of $3,000 and a marital deduction of $5,000(one half of $10,000). The net gift will be only $2,000.

The marital deduction is allowed for absolute gifts of property. It is, however, disallowed with respect to terminable interests.

The martital deduction may be applied towards an interest transferred in trust by a donor spouse provided that requirements, similar to those set forth in the estate tax amendments, are complied with.

Furthermore, a new subsection (f) was added to Section 1000 of the Code by Section 374 of the 1948 Revenue Act. A gift made after April 2, 1948, the date of the enactment of the 1948 Revenue Act, by one spouse to any other person than his spouse will be considered as made one half by him and one half by his spouse. The splitting of gifts made by either spouse to third parties is not mandatory. It is permitted only if both spouses consent. A consent signified with respect to any gift made during the calendar year will apply with equal force to all gifts made to third parties during such calendar year; and will apply to property held by the spouses as joint tenants or as tenants by the entireties.

The effect of the marital deduction, under the amendments to the gift tax statute made by the Revenue Act of 1948, is to make possible the transfer by gift between spouses of double the amount of property which could have been so transferred to such spouse free of gift tax prior to the enactment of the new law; and in the case of gifts by husband or wife to a third party to increase the amount of gifts which can be made free of gift tax by virtue of the additional exclusion and the additional specific exemption which will inure in favor of the spouse of the donor.

Amendment to the Gift Tax Regulations reflecting the changes made by the 1948 Revenue Act were published in the Federal Register on May 18, 1949.

COURT DECISIONS

Two cases, recently decided, are of interest with respect to the allowance of the annual gift tax exclusion. Since January 1, 1943, a donor is permitted a $3,000 annual exclusion for gifts made to each donee. Prior to 1943, the amount allowed was larger. The exclusion, however, does not apply to gifts of future interests. With respect to gifts in trust, the annual exclusion is usually allowed to the extent of the present value of the income beneficiary's right to the income of the trust.

In Jesse S. Phillips, 12 TC-No. 32 (1949), the petitioner transferred a life insurance policy in trust, with the direction to pay the net income therefrom to his wife during her life; and if the income was inadequate for her proper support and maintenance, to pay to her so much of the principal as might be necessary for such purpose. The Court held that the annual exclusion could not be applied because the insurance trust was non-income producing. Moreover, no exclusion results from the provision permitting the cash value of the policy to be paid to the beneficiary since such invasion is based upon a contingency which had not occurred at the time of the gift.

In Kniep vs. Commissioner, — F. (2d) — (CCA-8, 1949), the beneficiaries of a trust were to receive the annual income. In addition, the trustees were authorized to pay each beneficiary up to $1,000 if necessary for maintenance and support. For purposes of the annual exclusion, the Circuit Court based the value of the present right to receive the income on the commuted value of the income from the trust principal, reduced each year by $1,000. It was considered immaterial that the trustees might never dip into the principal to that extent.

As in the Phillips decision, supra, the Court refused to consider the right to invade the corpus as a gift of a present interest.

These decisions apply only to the annual exclusion. The $30,000 specific exemption is available for all gifts, irrespective of whether the gift is of a present or future interest.

1. *Transfers Incident to Divorce*—That the Commissioner's rulings are not sacrosanct was again illustrated in the case of Edward B. McLean, 11 TC 543 (1948) (non-acq.) (appealed to CCA-2, 1/4/49). Internal Revenue Bureau's ruling ET 19, 1946-2 CB 166, provides that transfers of property, pursuant to an agreement incident to divorce, are not for an adequate and full consideration to the extent that they are made in consideration of the release of marital rights other than right of maintenance and support; and hence are to be considered taxable gifts, under Code Section 1002.

In the McLean case, supra, the taxpayer and his wife, after protracted negotiations while a divorce action was pending, entered into a separation agreement whereby the taxpayer undertook to pay specified monthly amounts to his wife and to make lesser payments to her in the event of her remarriage. The commissioner contended, in the light of ET 19, 1946-2 CB 166, that the payments to be made to the wife after her remarriage constituted gifts. The Court held otherwise and rejected the Bureau's ruling. The Court could find no donative intent since the agreed payments to be made to the wife both before and after marriage were the result of bargaining which had as its sole objective the securing of the most advantageous terms.

V

Looking Ahead

The impact of Federal taxation on the economic life of the nation in recent years has been tremendous. It has become one of the most important factors affecting the business and social life of the American community. The year 1949 opened with a request by President Truman to the Congress for an increase in Federal taxation to stem the tide of threatened inflation. The continued downward economic course in business since then and the assumption of additional financial responsibilities by the nation has halted this inflationary trend. At the same time, a deficit in the Federal budget of approximately four billion dollars is indicated. The solution to this problem poses the following alternatives—either to increase taxes to meet the deficit or to reduce the budgetary requirements by the necessary amount. Each approach has its advocates. The President stands firm in his demand that Congress increase taxes. A considerable body of responsible leadership prefers to reduce the budget and wishes to avert the increase in taxation, being of the opinion that it might defeat its own purpose by converting the current deflationary trend into a sharp recession.

All indications now point to the fact that there might not be time at this session of the Congress to consider a new revenue bill; but that it will probably become an early order of business at the next session.

The Treasury is considering the inclusion of the following items in the new bill:

1. Credit for dividends received by a parent corporation from a foreign subsidiary.
2. Where a corporation receives a dividend in kind, the credit should be limited to 85 per cent of the adjusted basis of the property in the hands of the distributing corporation.
3. A provision different from the present 3 per cent rule on annuities.

The Treasury recommends the allowance of an annual exclusion equal to the consideration paid for the annuity divided by the life expectancy of the annuitant at the time the payments commence. This exclusion would be allowable for life.

4. The treatment of a partnership distribution to heirs of a deceased partner as income of the decedent, so there will be no over-lapping of income and estate tax.

5. Relaxation of the involuntary conversion provision to allow replacement of the destroyed property prior to receipt of insurance proceeds; and also easing the restrictions concerning the tracing of the proceeds.

6. Some provision which will prevent manipulation of long and short positions in substantially identical securities.

7. A general revamping of the provisions relating to the taxability of income of estates and trusts.

8. A change in the provisions dealing with corporate liquidations to eliminate problems resulting from the Court Holding Company case.

9. The provision in HR 6712 of the 80th Congress relating to stock options is still being considered. The Treasury does not favor it.

10. Other situations which might be treated are mortgage foreclosures, the capital gains structure and net operating losses.

The author gratefully acknowledges the assistance of his associate, Harry Yohlin, Esquire, in the preparation of this paper.

CHAIRMAN DIXON: We have come to what I feel is a rather solemn point in this program. That is the point at which we must reluctantly bring proceedings to a close. I have thought, prior to now, that all the hospitality of the nation was south of the Mason-Dixon line, but a great deal of it has seeped up this way.

Some folks have been wearing red carnations, and others white carnations. Somebody told me the red were for the living. Perhaps you will also have recognized the fact that only the people with white carnations have been making noises through this microphone. The red carnations actually have identified our hosts, the Accounting Department of the Ohio State University College of Commerce and Administration.

I had an opportunity to talk with Hermann Miller this morning at breakfast and I asked if I might, over his dead body, call on him for a remark or so at the close of the meeting. He insisted that I not do it. I don't believe that one man should decide that matter. Are you, as an audience, willing to decide whether Professor Miller say a word at this time?

MR. MILLER: Thank you very much. I thank you, not only for myself, but for my colleagues who have worked all year, thinking and planning for this great occasion. I want to thank you for the very splendid enthusiasm which you have shown, for the very splendid expressions of good will toward our University on the occasion of its 75th Anniversary—its 75 years of growth through service. We hope to continue that growth through service in the years ahead.

We expect to continue with these Institutes annually. Many people have asked me why we happened to have the Institute at a certain time, because it usually develops that it conflicts with certain other affairs. It is pretty hard to avoid those conflicts, but we have established the third week in May as the time for our annual Institute, Friday and Saturday of the third week. That is an established custom of long standing, and we hesitate to make any break in it. So we will continue in the future on that schedule.

I want to express my very grateful appreciation to our guest speakers who have given us such a splendid program. This Institute frightens me somewhat, because I feel that we have reached a new high level, and I am reminded of some of the things my friend Howard Greer said yesterday. When a man gets to the top in his organization, he is a man without a future. I am frightened sometimes that we have reached the top in Institutes of this kind, and I wonder whether we still have a future. I hope we have, and my colleagues assure me that they still have some ideas.

I want to tell you that this is not a one-man show. I have had wonderful assistance and enthusiastic support from the members of the Department of Accounting at the University.

Some of my past secrets were exposed yesterday morning by my friend, Howard Greer, when he told you of some of the dark side of my past. Then last evening one of our guest speakers went on and exposed the secret of the success of planning this program. I am afraid more and more of my secrets have been disclosed as the meeting has gone along, although I still have an ace up my sleeve. Since you have all the others, you might as well know that ace is this splendid group of men who are my colleagues, listed on the back page of the program. I want to call to your attention the fact that they are not professors and teachers of accounting only, living in an ivory tower, but they are very much interested in the affairs of these various national and state accounting organizations.

We have a very deep seated love for the organizations to which we belong. They mean more and more to us as time goes on, and I think you can all attest that fact from your own experiences in attending your various meetings. We attend these meetings and we learn to know each other better and to become more intimately acquainted. We exchange many views and we come away enriched in many ways. If we are to succeed in teaching in the classroom, it is absolutely essential to us. We cannot afford to go without them. I don't know how the man who is in public accounting practice or industrial accounting work, or managing a business organization can afford, either, to be without that constant association with other men in similar lines of work. Much of our success is rooted in the splendid enthusiasm that our faculty have for all these associations which have been represented on this program, as they have been in the past, and we hope they shall continue to be in the future.

We have a very splendid environment in which to work at Ohio State University. We have, as you learned last evening, a Dean who is behind us all the way. In fact, maybe that isn't the right way to state it. I am not sure whether he is in front or behind us. Sometimes I think he is behind, driving us ahead, and at other times I feel he is in front, pulling us along. At times, he seems to be on both sides.

It is encouraging to operate in an educational institution where you have no dead hand of administration holding you back. I can assure you, we are very fortunate in that respect. The President of the University and his administrative assistants, also, give the same kind of enthusiasm and support to the work we are attempting to do.

Again, we are fortunate in being here in the capital of the State of Ohio, centrally located, with friends, many of them in the surrounding cities not too far away, with whom we enjoy meeting, in their organizations—the NACA Chapters, the Ohio Society of Certified Public Accountants, the Comptrollers Institute, the Institute of Internal Auditors, and the American Accounting Association, and our colleagues in the neighboring universities and colleges.

I do not know of any place where the atmosphere is as gracious for anyone to do a good job. We ought to do a good job! We ought always to be doing a better one! That is one of the things that always bothers me. Because to continually be doing a better job is really a challenge. We have had good luck, I will say, in being able to attract to this program the top speakers in the country, whom we know in the field of accounting.

Over the years, as you know, we publish these proceedings, albeit we are slow in getting them out, and many people seem to be rather restless about it. That is something that is beyond our control, although there is always something you can do about these things, and we are going to try to do something about it. Our print shop at the University is greatly overloaded, with the same kind of plant which it had when they had half or a third as many students as today. They print the Bulletins for the various ten colleges, and other University publications, including these proceedings. For that reason, after the manuscripts are sent to the print shop, it is usually many months before the proceedings are returned and mailed out.

Our Bureau of Business Research does a great deal of work in this connection. The editorial work on these proceedings, the mailings, the announcements, and the programs are accomplished by the Bureau of Business Research. The Bureau keeps the address cards for all who are on our list to receive notices. We have about 4,500 names, and it is quite a job to keep these addresses corrected from time to time.

We would always appreciate it if you would give us any change of address, and let us know if you are not on the mailing list and not receiving our announcements. We would like to hear about it so our addressograph plates can be brought up to date. The proceedings are mailed out promptly as soon as they arrive from the printer, and they will be sent to you again this year at the earliest possible date.

A few years ago we started a little innovation. We were asked to furnish the papers prepared by our speakers for publication in the various technical journals of the various accounting organizations. As a result, many of the papers of our Institute were published in *The Journal of Accountancy*, in *The Controller*, in *The Accounting Review*, and in other publications, even including, in one instance, *The Accountant*, published by the British Chartered Accountants. That policy will be continued this year.

We have already had inquiries this year in advance. They now come to us ahead of time and say, "Can we have the papers your speakers are going to present? We would like to have them to publish."

These papers, undoubtedly, will be published in the various journals long before we will be able to get out our complete proceedings. We are very happy to do that, because we do not try to run any monopoly in this field. We are glad to have this information spread to all who may be interested in receiving it. So we always say to the editors of these publications, "We are happy to have you do that. All we ask is just that you give us a by-line credit."

Our Institute is for you. Many folks who have not attended an Institute at Ohio State University seem to have the feeling that an Institute on Accounting at a University must be held for the benefit of students primarily.

These Institutes at Ohio State University are for our colleagues on the firing line, although we are very happy to have our students, also. We invite them. We think it is very beneficial and stimulating for them. We are very proud to have them come and see the great leaders in the accounting profession who parade before us in this short span of time each year with their learned papers, and very interesting comments and discussions.

However, this Institute is not created for that purpose; it is created to serve you. Therefore, we would always be glad to have any of your thoughts or comments on how it is run, on what we can do to make it more comfortable, more enjoyable for you. What can we do to make the programs more interesting? If you have any suggestions, please jot them down in a note and mail it to me. They will be greatly appreciated.

In behalf of my colleagues who have worked so hard all year in planning and in making the arrangements here during these days and in the days immediately preceding, I want to thank not only our speakers, but also this very splendid and attentive audience—a very enthusiastic group of friends whom we cherish with our very greatest and deepest emotion. We are proud that this Institute has been a part of the year-long celebration of the Diamond Jubilee of the Ohio State University, and we look forward to seeing you again next year and in the years to come.

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